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<thead>
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<th>Title</th>
<th>The Expropriation Game: Minority Shareholders' Protection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Author(s)</td>
<td>Goo, SH; Weber, RH</td>
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<tr>
<td>Citation</td>
<td>Hong Kong Law Journal, 2003, v. 33 n. 1, p. 71-98</td>
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The Expropriation Game: Minority Shareholders’ Protection

Say H. Goo* and Rolf H. Weber**

Many Hong Kong companies, including listed companies, are controlled by a small group of shareholders with family ties. The inadequacy of the law has made it possible for controlling shareholders to expropriate corporate assets by using complex corporate structures to the detriment of minority shareholders. This article analyses the inadequacy of the law on the appointment of directors, self-dealing and shareholder legal remedies, and the current proposals for legislative reform. Drawing on the experience of some Western European countries where dominant shareholding is also a strong feature, it argues that such problems can be overcome by having a system of law and regulation which provides adequate shareholder protection and effective enforcement of such law.

Introduction

Many listed companies in Hong Kong are controlled by a small group of controlling shareholders who often have close family ties with each other.1 This feature prevails in many Asian economies,2 with the exception of Japan,3 and has been identified as a possible key contributing factor to the Asian financial crisis. However, this feature is not unique to Asia. Family-controlled groups are also prevalent in Continental Europe, yet Continental Europe appears to have dealt with the risks posed by “crony capitalism” more successfully than has Asia.

What seems to distinguish the family domination of Asian corporations from that in Continental European corporations is the ease with which the controlling shareholders may “expropriate” corporate assets to the detriment of minority shareholders through pyramid structures or privatisation. The controlling shareholders through a private holding company can sit at the apex, and the listed companies at the base of the pyramid can be used as

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3 48.4% in South Korea, 48.2% in Taiwan, 61.6% in Thailand, 67.2% in Malaysia and 9.7% in Japan in 1996-1997: Lang and Young (n 1 above).
stalking horses for cash. The amounts raised are passed up the pyramid through related party contracts or transactions. Other less profitable or desired assets are passed down the pyramid to the listed companies.\(^4\) Other examples of expropriation involve simple disposal of the most valuable company business or assets to a company owned by the controlling shareholders, or privatisation.\(^5\) Limiting expropriation by controlling shareholders, rather than restricting empire building by unaccountable managers, is therefore the primary agency issue for large corporations in East Asia.\(^6\)

The risk of expropriation may lead to large social costs, as profitable investment opportunities are foregone for lack of equity financing.\(^7\) Thus, measures should be taken to reduce such a risk. The degree to which certain ownership structures are associated with expropriation depends on country-specific circumstances which may include the quality of banking systems, the legal and judicial protection of individual shareholders and the degree of financial disclosure required.\(^8\)

Focusing on the situation in Hong Kong, this article argues that the current law is inadequate to address the dominant shareholding problems and that the proposals for reform in the consultation paper published by the Standing Committee on Company Law Reform (SCCLR) are long overdue. It further argues that the experience in Continental Europe demonstrates that these problems can be overcome if the system of law and regulation provides adequate shareholder protection and effective enforcement of such law. The article analyses Hong Kong’s existing and proposed future legal rules in light of the experiences of several Continental European countries.

**The Three Issues**

Many listed companies in Hong Kong started life as small family owned businesses. When they became successful, many of these businesses were publicly listed by floating 25 per cent or more of the company shares. This allowed the companies to raise funds from the stock market to finance further expansion or for other purposes. Following the public float, the founders, who retain a major stake as controlling shareholders, often continue to treat

\(^4\) Ibid. See also Michael Backman, *Asian Eclipse: Exposing the Dark Side of Business in Asia* (Singapore: John Wiley & Sons, 2001), pp 83–86.

\(^5\) For example, in Apr 2002, Boto International Holdings Ltd, one of the territory’s many publicly traded but family-controlled companies, announced plans to sell its manufacturing operations to an entity co-owned by Boto’s own chairman, Michael Kao Cheung-chong, and by the Carlyle Group, a US$13 billion US private investment firm: see http://www.time.com/time/asia/magazine/article/0,13673,501020527-238666,00.html. This plan was modified later due to strong opposition from minority shareholders: see http://www.webb-site.com/articles/botodeal2.htm.

\(^6\) See Claessens, Djankov, Fan and Lang (n 2 above), p 2.

\(^7\) Ibid., p 29.

\(^8\) Ibid.
the companies as their own private property, and the investing public who are the minority shareholders are seen as mere providers of funds, not as shareholders or co-owners to be treated equally. As a result of their dominance, the controlling shareholders are able to appoint themselves or their nominees as directors of the listed companies. Through their control over the management and ultimately the general meeting, they are able to exercise executive power in a manner which is beneficial to themselves.

While operating in a manner beneficial to the controllers' private interest is often in the broader interests of the company and its shareholders, this is not always the case. This is because the controllers can move the company assets around within a group structure or privatise the company as they see fit, even if this means the minority shareholders will lose out in sharing in the success of the company. Often there is very little that minority shareholders can do to stop these activities, either at the general meeting or by way of legal action. This is partly due to the fact that our current law and regulation favour majority shareholders too much. In particular, three areas of concern need to be addressed: the appointment of directors; self-dealing or related party transactions; and shareholder legal remedies.

1 Appointment of Directors

(a) The current position
Shareholders are entitled to nominate directors, but often the articles of association do not allow enough time for nominations to be made. Nominations must be made within 21 days of the meeting at which the nominations will be voted. However, in the case of a listed company, the Listing Rules require that the minimum period during which notice to the issuer of the intention to propose a person for election as a director, and during which notice to the issuer by such person of his willingness to be elected may be given, will be at least seven days, but that the latest date for lodgement of the notices must be not more than seven days prior to the date of the meeting appointed for such election. Shareholders who make nominations often have to bear the costs of circulating details of nominees to other shareholders. Thus, in practice, the management has significant control over the nomination process. As the management of many companies is in the hands of the controlling shareholders, the controlling shareholders have ultimate control over the nomination and appointment of directors.

9 Companies Ordinance (Cap 32), First Sch, Table A, Art 95.
10 Listing Rules, App 3, para 4(4).
11 Ibid., para 4(5).
13 Ibid., para 10.11.
Furthermore, although the directors are appointed by shareholders at the general meeting, the controlling shareholders can and do exercise their power in voting for themselves, their nominees or preferred candidates as directors.

(b) Proposals for reform
To overcome the problems in the nomination process, the SCCLR proposes, inter alia, that there should be a statutory requirement for the biography of a nominee to be given to shareholders in sufficient time and for the existing period for making nominations to be extended.\(^\text{14}\) Most corporation laws in Continental Europe provide (equally for listed and non-listed companies) for a longer period of at least 15 days for nomination.\(^\text{15}\)

The SCCLR also recommends that companies should be encouraged to adopt cumulative voting procedures,\(^\text{16}\) by which the shareholders can accumulate their votes for each nominee and vote them all for one nominee. This type of voting would give minority shareholders better chances of voting for their preferred candidates. Similar rules exist in a number of Continental European countries. For example, Spain\(^\text{17}\) has rules which protect minority shareholders through the use of proportional voting rights (which are a type of cumulative voting that favours minority shareholders) and in Switzerland\(^\text{18}\) shareholders in each share class have a right to appoint a director without the interference of other share classes.

The SCCLR’s proposals are supported by the authors because giving shareholders rights to have a real opportunity to nominate their candidates and to vote them in by cumulative voting is one possible way to strengthen the power of minority shareholders. Of course, there is nothing to prevent the majority shareholders from using the cumulative procedure to outvote the minority on a particular candidate, but it does give the minority extra room to manoeuvre. One argument against cumulative voting is that it could create opposition within the board which may not be in the best interest of the company. However, some constructive opposition in the board can be very healthy.

2 Related Party Transactions
The main problem for minority shareholders is expropriation or privatisation by the controlling shareholders through related party transactions. While in the case of listed companies there are many rather complicated provisions in

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\(^{14}\) Ibid., para 10.29(a)–(b).
\(^{15}\) For example, in Germany at least one month: § 123, Aktiengesetz; in Switzerland at least 20 days: Art 700 of the Swiss Code of Obligations; and in France at least 15 days: Art 126 of Décret no 67-236 of 23 Mar 1967.
\(^{16}\) SCCLR Consultation Paper (n 12 above), para 10.27.
\(^{17}\) P. V. Kunz, Der Minderheitenschutz im schweizerischen Aktienrecht (Bern: Staempfl, 2001), § 17, n 169.
\(^{18}\) The Swiss Code of Obligations, Art 709 al 1.
the Listing Rules for such transactions, there are gaps in the regulations which make it possible for these sorts of transactions to take place.

(a) Existing law and regulations
At common law, any contract with the company needs board approval. As fiduciaries, directors must not place themselves in a situation where their personal interests conflict with the interests of the company. Thus, as a general rule, controlling shareholders who are also directors must not approve a contract in which they are interested.19

As this strict rule can work against the company's interest in a genuine contract, in equity, directors who have approved a contract in which they have an interest can be relieved of the breach of their fiduciary duties by the shareholders in a general meeting after full disclosure.20 However, shareholders do not owe any fiduciary duty to each other; they are perfectly entitled to put their personal interests before those of the company when they vote at the general meeting.21 Consequently, the controlling shareholders/directors may, as shareholders, vote at the general meeting to approve the contract or ratify the breach.22 Although doubts have been raised as to whether interested shareholders can actually vote,23 the position in case law has never been authoritatively clarified.24

Section 162 of the Companies Ordinance attempts to resolve the problem of conflict of interest by requiring any director of a company who is in any way, directly or indirectly, interested in a contract or proposed contract with the company, if his interest in such contract or proposed contract is material, to declare the nature of his interest at the earliest meeting of the directors at which it is practicable for him to do so, notwithstanding that the question of entering into the contract is not taken into consideration at that meeting.25 The intention is that with full disclosure of interests, the board of directors can make an informed decision as to whether to approve the contract.

There are a number of problems with section 162. First, a director may satisfy the disclosure requirement of section 162 by giving a general notice at his first board meeting declaring his interest in a list of companies well in advance of any proposed related party transaction with any of those companies.26 Once

19 Regal (Hastings) Ltd v Gulliver [1942] 1 All ER 378.
20 Ibid.
21 Northwest Transportation Co. Ltd v Beatty (1887) 12 App Cas 589.
22 Regal (Hastings) Ltd (n 19 above).
23 Cook v Deeks [1916] 1 AC 554, PC.
25 Companies Ordinance, s 162(1).
26 Ibid., s 162(2).
a general notice has been given, it is not necessary for the director to disclose his interest in a specific transaction later. Such an advance general disclosure which does not relate to any specific transaction is often promptly forgotten when a related party transaction is later considered by the board. Even if a director has not given a general notice, he can disclose his interest at the earliest meeting where it is practicable to do so; he does not have to disclose his interest to the meeting at which the contract is considered. This does not give the board a real opportunity to consider whether the contract is genuinely in the best interest of the company. Therefore, section 162 should be amended along the lines of section 317 of the UK Companies Act 1985 which requires the disclosure to be made at the meeting at which the question of entering into the contract is considered; if he is not interested at the time, the disclosure should be made at the first meeting after he becomes interested.

Second, after full disclosure, interested directors can often vote to approve the contract. Although Article 86 of Table A says that interested directors cannot vote on such a contract, this provision can be and often is altered. This rule allows the directors to exercise their influence by voting despite the conflict of interest. And in the case where the directors have control over the board, the rule does not really protect shareholders. This is fortunately not the case in a listed company as the Listing Rules provide that the articles of association of a listed company must have a general prohibition against an interested director voting. However, it does not prevent a director from voting if his associates are the ones interested in the contract.

In a number of Continental European countries, a director with such a conflict of interest may neither deliberate nor vote with the company board on such a transaction. If a decision is taken by directors that unjustifiably gives rise to a direct or indirect conflict of interest of an economic nature, the directors are jointly and severally liable for all damages to the company. Under the Swiss Code of Best Practice, adopted in autumn 2001 and released in March 2002, each member of the Board of Directors and Executive Board should arrange his personal and business affairs so as to avoid conflicts

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27 Ibid., s 162(1).
28 Listing Rules, App 3, para 4(1).
30 That is, a member of the supervisory board.
32 Available at http://www.economiesuisse.ch/d/downloads/swisscodeofbestpractice_english.pdf. The Code does not have binding legal effect since it is a form of self-regulation by an association of market participants. However, the Code has a “soft law” character.
of interest with the company. In case a conflict of interest arises, the member of the Board of Directors or Executive Board concerned should inform the Chairman of the Board. The Chairman, or Vice-Chairman, should then request an appropriate decision by the Board of Directors on the matter depending on the degree of the conflict of interest. Such a decision must be taken in abstention of the person concerned. Anyone who has a conflict of interest, or who represents such a person, must abstain from decision-making at the board. Anyone with permanent conflicts of interest must not be a member of the Board of Directors or Executive Board.

Third, section 162 only covers contracts. This leaves open the possibility of directors entering into "transactions or arrangements" which are short of contracts in their technical sense and that do not comply with section 162. Of course, such transactions or arrangements may still be caught by the somewhat ill-defined common law explained above.

Fourth, section 162 only applies to a contract between the company and the director, and not to a contract between the company and connected persons (such as the controlling shareholders who are not directors). This is a loophole which allows directors and connected parties to escape the reach of section 162. The directors appointed by the controlling shareholders can approve, in accordance with the controlling shareholders' wishes, the transaction in which the controlling shareholders are interested without breaching their fiduciary obligations and section 162. In Continental Europe, this is not allowed. For example, under the Swiss Code of Best Practice, transactions between the company and members of the company, or related persons, can only be carried out subject to the principle of arm's length dealing and be approved in abstention of the party concerned. If necessary, a neutral opinion from an independent director or expert should be obtained and used as an interpretation guideline for their own decision.

Fifth, section 162 does not prejudice the operation of any rule of law restricting directors of a company from having any interest in contracting with the company. Thus, even when a contract has been approved by the board after full disclosure, it can still technically amount to a breach of the director's fiduciary obligations and need to be ratified, if ratifiable, by the shareholders in the general meeting. Ratification is not a problem for the controlling shareholders, however, as they will control the necessary votes.

Related party transactions in listed companies are basically regulated in three ways under the Listing Rules, depending on whether the transaction involves: (a) a very substantial acquisition and major transaction; (b) a discloseable transaction and share transaction; or (c) a connected transaction.

33 Companies Ordinance, s 162(5).
34 For example, following Regal (Hastings) Ltd (n 19 above). But see Cook v Deeks (n 23 above).
A very substantial acquisition is any acquisition by a listed company or its subsidiaries of another business, assets, company or companies, substantially all of which are not listed, and:

1. the value of the assets acquired represents 100 per cent or more of the assets or consolidated assets of the acquiring group; or
2. the net profit attributable to the assets being acquired as disclosed in the latest published audited accounts represents 100 per cent or more of such net profit of the acquiring group; or
3. the aggregate value of the consideration given represents 100 per cent or more of the assets or consolidated assets of the acquiring group; or
4. the value of the equity capital issued as consideration given represents 100 per cent or more of the value of equity capital previously in issue; or
5. would result in a change in control through the introduction of a majority holder or group of holders. 35

A major transaction is any acquisition or realisation of assets (including securities) by a listed company or any of its subsidiaries where the bases set out in the rule relating to a very substantial acquisition mentioned above are 50 per cent or more. 36

Although a very substantial acquisition or a major transaction can only be made upon approval by the shareholders in a general meeting or with the written approval of a shareholder or shareholders who hold more than 50 per cent in nominal value of the shares giving the right to attend and vote at such a general meeting, there are a number of gaps in the rules. This is the case even when a shareholder who has a material interest in the transaction is not allowed to vote at such a meeting or whose written approval is not accepted. 37 First, transactions which fall below the bases set out in the rule are obviously not covered by the rule. This means that many transactions which fall below the 50 per cent base do not need to be approved by disinterested shareholders; they are merely regulated as discloseable or share transactions as explained below.

Secondly, material interest is not defined in the listing rules. The way in which the Exchange interprets the term has recently attracted some criticism. 38 In a revised proposed sale by Boto International Holdings Ltd of its core artificial

35 Listing Rules, r 14.06.
36 Ibid., r 14.09.
37 Ibid., rr 14.07(1) and 14.10.
Christmas tree business to Greenland Investment Holdings Ltd (GIHL) (a buyout vehicle owned 75 per cent by Carlyle and 25 per cent by Boto), the Exchange allowed three shareholders of Boto, who apparently had a conflict of interest in the proposed sale, to vote. The three shareholders were executive director Liliana Tsen Yun-lei, senior manager Philip Kao and HSBC International Trustee which held Boto shares on behalf of a family trust of a deceased co-founder. The Exchange obviously thought that each of the three parties did not have a material interest in the proposed sale: it said that it would be wrong to disallow Liliana Tsen from voting simply because she was an employee of the company, or Philip Kao just because he was a nephew of the chairman; and as for the trust's beneficiaries, they were independent because they were no longer involved in Boto's operation. Critics argue that the three parties should not have been allowed to vote because they each had a potential conflict of interest: Tsen was a member of the board that proposed the deal; Kao was a nephew of the chairman who would still sit on the board of the acquiring company and would receive substantial fees (under the deal, Boto would sign a three-year consultancy agreement by which the services of certain directors of Boto, including its chairman, Michael Kao, would be provided to GIHL in return for fees of HK$11.2 million per year plus a discretionary fee based on GIHL's financial performance); and HSBC International Trustee was providing financing for about 80 per cent of the purchase price of the deal. The deal was approved by “independent shareholders” including the three parties by a narrow margin of 52.74 per cent.

Thirdly, a point related to Philip Kao’s position in the Boto / GIHL deal, the rule does not prevent an associate of the interested controlling shareholder or of a director from voting. Technically, it may be possible to argue that Philip Kao did not have a material interest in the proposed deal if he did not personally stand to gain from it despite his family relationship with Michael Kao. However, as a close relative, and thus an associate, he would not have been allowed to vote had the transaction been a connected transaction, as will be seen below. One wonders whether the distinction between a major transaction and a connected transaction in relation to voting by an associate is justifiable.

A discloseable transaction is any acquisition or realisation of assets (including securities) where the bases are 15 per cent or more and includes both very substantial acquisition and major transactions. A share transaction is any acquisition of assets (including securities but excluding cash) where the bases are less than 15 per cent but the consideration includes securities for which listing will be sought. Neither a discloseable transaction nor a

39 Ibid.
40 Listing Rules, r 14.12(1).
41 Ibid., r 14.20.
share transaction requires disinterested shareholder approval. But as soon as
the terms of the transaction have been agreed the listed company must in-
form the Exchange and deliver to it a draft notice containing certain prescribed
information, including the details of the transaction.\(^4\)

A connected transaction is: (a) a transaction between a listed company
(or its subsidiaries) and a connected person;\(^4\) or (b) an acquisition or
realisation by the listed company (or its subsidiaries) of an interest in a com-
pany whose substantial shareholder is or is proposed to be a director, chief
executive or controlling shareholder of the listed acquiring or realising com-
pany (or its subsidiaries) or their associates.\(^4\) Boto’s initial proposed sale to a
company owned 70 per cent by Carlyle and 30 per cent by Michael Kao would
have fallen into category (a).

Connected transactions are generally to be made conditional on approval
by the shareholders in the general meeting and that any connected person
interested in the transaction must abstain from voting at the meeting.\(^4\) The
requirement is slightly stricter than that for a major transaction in that an


\(^4\) A connected person means a director, chief executive or substantial shareholder of the listed com-
pany or any of its subsidiaries or an associate of any of them (*ibid.*, r 1.01) and includes: (a) any
person or company with whom they have entered, or proposed to enter, into an agreement,
arrangement, understanding or undertaking, whether formal or informal and whether express or
implied, with respect to the transaction; and (b) any person cohabiting with them as a spouse; or (c)
you of their relatives, including: (i) a child or step-child aged 18 or over; (ii) a parent or step-parent;
(iii) a brother, sister, step-brother or step-sister; or (iv) a mother-in-law, father-in-law, son-in-law,
daughter-in-law, brother-in-law or sister-in-law (*ibid.*, r 14.03(2)).

\(^4\) *Ibid.*, r 14.23(1). Associate means: (a) in relation to any director, chief executive or substantial
shareholder (being an individual): (i) his spouse and any of his (or his spouse’s) children or step-
children under the age of 18 years (ie family interest); (ii) the trustees, acting in their capacity as
such trustees, of any trust of which he or any of his family interests is a beneficiary or, in the case of
a discretionary trust, is a discretionary object; and (iii) any company in the equity capital of which
he and/or his family interests taken together are directly or indirectly interested so as to exercise or
control the exercise of 30% (or such lower amount as may from time to time be specified in the
Takeover Code as being the level for triggering a mandatory general offer) or more of the voting
power at general meetings, or to control the composition of a majority of the board of directors and
any other company which is its subsidiary or holding company or a fellow subsidiary of any such
holding company; and (b) in relation to a substantial shareholder (being a company) means any
other company which is its subsidiary or holding company or is a fellow subsidiary of any such
holding company or one in the equity capital of which it and/or such other company or companies
taken together are directly or indirectly interested so as to exercise or control the exercise of 30% (or
such lower amount as may from time to time be specified in the Takeover Code as being the level for
triggering a mandatory general offer) or more of the voting power at general meetings, or to control
the composition of a majority of the board of directors (*ibid.*, r 1.01). Note, however, that in the
case of a connected transaction falling within r 14.23(1)(a) only, a company is not an “associate” of
a director, chief executive or substantial shareholder of a listed issuer by virtue only of the director’s,
chief executive’s or substantial shareholder’s indirect interest in that company through his interest
in the listed issuer, and in the case of a connected transaction falling within r 14.23(1)(b) only, the
listed acquiring or realising issuer is not an “associate” of the director, chief executive or controlling
shareholder, when the listed acquiring or realising issuer is acquiring or realising an interest in a
company in which it is already a substantial shareholder and a director, chief executive or control-
ling shareholder shall not be taken to be a “substantial shareholder” in a company by virtue only of
the director’s, chief executive’s or controlling shareholder’s indirect interest in that company through
his interest in the listed issuer (*ibid.*, r 14.03(3), (4)).
associate, being a connected person, cannot vote to approve the transaction. However, one major gap in the existing regulation is that the rule does not apply to a transaction between the director (or connected person) of a listed company and an associated company of the listed company, that is a company which is less than 51 per cent owned by the listed company. Thus, it is possible for directors or controlling shareholders to use a pyramid structure to transact with a company in which the listed company holds less than 51 per cent of the shares (an associated company, not a subsidiary) without the approval of the listed company's shareholders unless the transaction is a major transaction where the requirement of shareholder approval is less stringent, for example selling unprofitable assets to an associated company at inflated prices or acquiring profitable assets from an associated company under-value. Neither does the rule apply to a transaction between a listed company and its associated company. As mentioned, Boto's original deal would have been regarded as a connected transaction and all connected persons, including Philip Kao, would have been barred from voting to approve the deal. However, the deal was later revised so that Michael Kao would not be an owner of the acquiring company but that Boto would retain a 25 per cent stake in it. The deal became a proposed sale to an associated company, Boto retaining a 25 per cent stake in the acquiring company (which was not enough to be Boto's subsidiary). The deal was therefore no longer a connected transaction.

Also, it is possible for a listed company to be granted a waiver by the Exchange from the relevant requirements, including the requirement of disinterested shareholder approval. Unfortunately, the Exchange has not been very transparent on the criteria for granting a waiver.

Apart from the Listing Rules, which apply only to listed companies, there is no statutory provision in the Companies Ordinance requiring shareholders' approval and the abstention of voting by interested shareholders for a related party transaction. Of course, where the director (or connected person) enters into a related party transaction with a non-listed company's subsidiary which is a listed company, the transaction may be governed by the Listing Rules as discussed above. However, the gaps in the existing rules make it possible for regulatory arbitrage to occur. As a result, some related party transactions

46 SCCLR Consultation Paper (n 12 above), paras 9.02–9.04.
47 In some Continental European countries, such practices are a strong legal ground for a liability claim against a director personally; for Austria see F. Pegger, "Austria", in Maitland-Waller (n 31 above), pp 1–27. Examples of management board members' liability are where: (a) contributions are refunded to the shareholders; (b) interests or shares in the profits are paid to the shareholders; (c) the company purchases its own shares by subscription, takes them in pledge or by redemption; (d) shares are issued before all the capital is paid in; (e) the company's capital is distributed; or (f) loans are granted.
48 SCCLR Consultation Paper (n 12 above), paras 3.01(executive summary) and 8.03. One exception is in relation to the payments to directors in connection with the loss of office which requires shareholders' approval: s 163A of the Companies Ordinance.
remain unfair to minority shareholders even though technically they may be in compliance with the rules. Rule changes are needed to deal with this problem.\(^4\)

(b) The proposed reform

A number of proposals have been made both by the SCCLR and the Hong Kong Exchanges and Clearing Limited (the HKEx) (the parent company of the Hong Kong Stock Exchange (SEHK) which is the front-line regulator of companies listed on the Exchange)\(^5\) to deal with the problems identified above.

To strengthen the statutory provisions which apply to all companies, first, the SCCLR proposes that the scope of section 162 of the Companies Ordinance be extended to include transactions and arrangements, and to cover contracts, transactions or arrangements with "connected persons".\(^5\)

Second, it proposes that an interested director should be required to make a disclosure of his interest on an ad hoc basis, in addition to the general notice in advance.\(^5\) Furthermore, a director should not be allowed to vote at a board meeting on the contract or transaction in which he or a connected person has an interest.\(^5\) The HKEx has made a similar recommendation recently in its consultation paper\(^5\) proposing that the Listing Rules be amended to extend the prohibition against a director voting in a contract in which he is interested to one in which his associates are interested.\(^5\) This recommendation is to

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\(^5\) Under a memorandum of understanding between the Securities and Futures Commission (SFC) and the Hong Kong Stock Exchange (SEHK) dated 25 Nov 1991 and replaced by an amended memorandum of understanding dated 6 Mar 2000, the SEHK became the frontline regulator for the companies listed on it, except the HKEx which is regulated by the SFC: available at http://www.hkex.com.hk. However, the HKEx Board of Directors does not exercise the functions and powers over listing matters, but has instead delegated those functions and powers to its Listing Committee. In practice it is the Listing Division of the Listing, Regulation and Risk Management Unit of the HKEx that has the responsibilities for initiating any proposed changes to the Listing Rules. It usually works closely with the Corporate Finance Division of the SFC on draft proposals which will be considered and discussed by the Listing Committee before they are released to the public for consultation. After such consultation, the revised proposals will be put to the Listing Committee for formal consideration and approval, and then subsequent approval by the HKEx's Executive Committee, the Board of Directors of the SEHK and finally the SFC. For a detailed account of the procedure for amendments to the Listing Rules, see ch 5 of the recent Report of the Panel of Inquiry on the Penny Stocks Incident prepared by the panel of inquiry which consisted of Messrs Robert G. Kotewall and Gordon C. K. Kwong, published on 9 Sept 2002 (hereinafter the Penny Stocks Report), available at http://www.info.gov.hk/info/pennystock-e.htm.

\(^5\) SCCLR Consultation Paper (n 12 above), para 7.09(f).

\(^5\) Ibid., para 7.09(a).

\(^5\) Ibid., para 7.09(a). The SCCLR also proposes three exceptions: (a) where the directors' interest is "immaterial" (ie one that does not give rise to a risk of actual conflict); (b) in a contract relating to a loan to the company, where the director gives a guarantee for repayment of the loan; and (c) any proposed employee benefit scheme which may benefit the directors provided his entitlements are no greater than others in the same class: ibid., para 7.09(b).

\(^5\) HKEx Consultation Paper (n 29 above).

be welcomed, as it will hopefully reduce the likelihood of abuses by directors by using their associates to circumvent the Listing Rules.

Third, given that there is generally no provision in the Companies Ordinance to require shareholder approval and abstention from voting by interested shareholders, and given that there are many gaps in the Listing Rules, the SCCLR proposes that there should be a general provision in the Companies Ordinance providing that where a contract is significant it should be approved by disinterested shareholders in the general meeting, and interested shareholders should not be allowed to vote. This proposal shares some of the thinking behind the legislation in a number of Continental European countries: for example, in Denmark and Sweden interested majority shareholders are required not to vote. Other countries have introduced a loyalty obligation for majority shareholders: for example, in Germany and Austria shareholders must give priority to the company interests in general, not to their own interest. The Hong Kong Institute of Company Secretaries supports this, with a major qualification which applies only to non-listed companies.

The SCCLR further proposes that the requirements of shareholder approval and abstention from voting by interested shareholders in the current Listing Rules be extended to contracts between the director (or connected person) and the company’s associated company. A company will be an associated company if the listed company holds no less than 20 per cent of voting rights in it. This proposal would make it more difficult for the directors / controlling shareholders to misappropriate corporate assets using a pyramid or cross-holding structure. It appears to be a good idea. The HKEx has made the same recommendation to regulate transactions between connected persons and associated companies as connected transactions, with a threshold of 20 per cent, arguing that this is in line with the international

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56 The test for deciding whether a transaction is "significant" is left open for consultation: See n 12 above, para 8.25. The Hong Kong Institute of Company Secretaries (HKICS) is in favour of a net asset test because it is more objective, and suggests that a transaction be regarded as significant if its value is more than 20% of the company's net assets, with an exemption of HK$100,000 or less: see HKICS's response to the SCCLR Consultation Paper (unpublished).

57 SCCLR Consultation Paper (n 12 above), paras 7.09(d), 8.27, and 9.08(b). These are already provided for under the Listing Rules for listed companies as mentioned above.

58 Kunz (n 17 above), s 17, nn 68, 216.

59 Ibid., s 17, n 157.

60 See G. Wiesner, "Kommentierung zum Aktiengesetz", in Münchener Handbuch des Gesellschaftsrechts, Bd. 4 (München: Beck, 2nd edn, 1999), s 17, n 16.


62 It thinks that this should not apply to cases where the company is nothing more than a vehicle for a very small group of shareholders (say a husband and wife) to hold an investment or asset. This situation is quite common in Hong Kong. If a husband and wife wish to sell to the company an apartment which they jointly own, what are they going to do if they cannot approve the transaction in the general meeting by their own votes? There are no other disinterested shareholders who can approve the transaction: See HKICS's response to the SCCLR Consultation Paper (unpublished).

63 SCCLR Consultation Paper (n 12 above), para 9.08(a).
accounting standard which was adopted in Hong Kong on 1 January 2001.\(^6^4\) While the proposal is sound in principle, it has been argued that the threshold should be 30 per cent rather than 20 per cent, because 20 per cent is not even enough to give the shareholder of the listed company a negative control to block a special resolution at the general meeting of its associated company when a vote on the transaction is taken.\(^6^5\)

These proposals are consistent with developments elsewhere in the world and should prevent directors and controlling shareholders from abusing their power. There is, however, no proposal to regulate a transaction between the listed company and its associated company as a connected transaction. Thus, cases such as the controversial sale by Boto of its artificial Christmas tree business to GIHL, in which it would retain a 25 per cent stake, would still be regulated as a major transaction.

(c) Other possible reforms
In addition to the above proposals, it may be appropriate to prohibit a list of contracts which are more likely to benefit the directors than the company because they result in debts to the company. For example, in Ireland\(^6^6\) a company is, as a general rule, prohibited from entering into the following transactions with a director: (a) the making of loans and quasi-loans as defined in the Act;\(^6^7\) (b) credit transactions, such as hire-purchase agreements and leasing arrangements; and (c) the provision of guarantees or other security for the benefit of a director.

3 Shareholders' Legal Remedies
Apart from the inadequacy of the law in respect of related party transactions, the other major problem which is often neglected by policy and law makers is the lack of an effective mechanism for shareholders to bring an action against directors or controlling shareholders for wrongdoing. Obviously, there is a need to maintain a proper balance between safeguarding the interests of the minority and preventing disgruntled shareholders from taking pointless shareholder actions against the company to the detriment of the company's interest. But the law and court practices do not appear to have struck an appropriate balance. Courts in Hong Kong seem to be more reluctant to allow shareholder actions than courts in Continental Europe. In

\(^{64}\) HKEx Consultation Paper (n 29 above), Part B, paras 26.1–26.9, 30.1–30.10.

\(^{65}\) See HKICS's response to the SCCLR Consultation Paper (unpublished).

\(^{66}\) See Part III of the Irish Company Act 1990; H. Ong and S. Hegarty, "Ireland", in Maitland-Waller (n 31 above), pp 299–319; similarly for Denmark see H. Peytz, "Denmark", in Maitland-Waller (n 31 above), at pp 143–157. The United Kingdom also has similar provisions: see Part X of Companies Act 1985.

\(^{67}\) This is already the case in Hong Kong under s 157H of the Companies Ordinance.
many countries, protection of minority shareholders has become an important area in the jurisprudence; particularly courts in Northern European countries (Denmark and Sweden) as well as Germany and Austria have frequently approved liability claims of minority shareholders against directors. In most cases, the causes of action are damages claims.

Currently, shareholders of listed companies have a number of possible legal remedies under Hong Kong law: the common law derivative action; the statutory remedies in connection with unfairly prejudicial conduct; and an action for breach of personal rights. As explained below, each of these is problematic.

(a) Derivative action
At present, there is little incentive for shareholders to take action against directors or the management for expropriation through derivative actions because of the technical difficulty in establishing a locus standi under the notorious rule in Foss v Harbottle. An expropriation is a wrong done to the company and an action should be brought by the company, not the minority shareholders, unless there is a fraud on the minority (which is the case with expropriation) and the wrongdoers are in control. Furthermore, they are potentially liable for costs and the exercise of discretion to award costs is uncertain. The court may award costs if the proceedings were brought about reasonably and in good faith. There is no contingency fee system in Hong Kong, nor is legal aid available for shareholder disputes. Any damages awarded belong to the company, not to the individual shareholders who brought the claim. Thus, other shareholders are able to free-ride on the benefit of the action. There is, therefore, an incentive not to bring any

70 See Wiesner (n 60 above), s 18, n 4 ff.
71 Petsch (n 61 above).
72 (1843) 2 Hare 461. See SCCLR Consultation Paper (n 12 above), paras 15.03–15.13. Also, as shareholders usually hold stock in the name of the Hong Kong Securities Clearing Company (Nominees) Ltd, they will need to establish their status as legal shareholders before they can sue, which adds another layer of complexity.
73 SCCLR Consultation Paper (n 12 above), paras 8.01(a) (executive summary), 15.14(a).
74 See Wallersteiner v Moir (No 2) [1975] QB 373, CA. In Switzerland, the judge is entitled to charge the company for the costs of procedure (including attorneys' fees) if the shareholder had an appropriate reason to start legal action notwithstanding its outcome (The Code of Obligations, Art 756 al 2). In Spain, the liability claim is a so-called group claim (see Kunz (n 17 above), s 17, n 170).
75 The Legislative Council has set up a working party to consider extending legal aid to shareholder disputes: see Jane Moir, "Legal-Aid Net under Review", SCMP, 11 Mar 2002, Business, p 1.
76 SCCLR Consultation Paper (n 12 above), paras 8.01(b) (executive summary), 15.14(b).
action. In addition, it is often difficult to obtain sufficient evidence to frame a claim.\(^{77}\)

The SCCLR’s proposal is that derivative action should be governed by statutory provisions instead of common law.\(^{78}\) The current procedure of having a preliminary hearing to determine whether the individual shareholder has standing to bring a derivative action should be abolished. Instead, all existing shareholders, directors and officers, past or present, should be allowed to bring a derivative action.\(^{79}\) It should no longer be necessary to show “fraud on minority”, as is currently required under common law; instead, the grounds for such action would include fraud, negligence, default in relation to any laws or rules, and breach of fiduciary or statutory duties.\(^{80}\) Where the action involves a transaction to be approved by disinterested shareholders, and such approval has not been obtained, the controlling shareholders who have an interest in the transaction should have to prove that the transaction was fair and not to the detriment of the company.\(^{81}\) Where the transactions are ratifiable, only disinterested shareholders may ratify such transactions.\(^{82}\) And the fact that a transaction has been so ratified should not be a bar to a derivative action; it should only be one factor in determining whether the company should receive redress.\(^{83}\)

The common law derivative actions in Hong Kong originate from the English case law and therefore, not surprisingly, derivative actions in Hong Kong and England face very similar problems.\(^{84}\) The English Law Commission has made a proposal for reform. The substance of its proposal is that derivative action should be available to any member if the case falls within the following situation, namely that if the company were the applicant, it would be entitled to any remedy against any person as a result of any breach or threatened breach by any director of the company of any of his duties to the company.\(^{85}\) This is essentially similar to the SCCLR’s proposed grounds for derivative action (which would include fraud, negligence, default in relation to any laws or rules, and breach of any duty, whether fiduciary or statutory). However, the English Law Commission proposes that the right to bring a derivative action should be subject to tight judicial control at all stages. In

\(^{77}\) Ibid., paras 8.01(c) (executive summary), 15.14(c).
\(^{78}\) Ibid., para 15.25.
\(^{79}\) Ibid., paras 8.02(a) (executive summary), 15.25(a).
\(^{80}\) Ibid., paras 8.02(d) (executive summary), 15.26.
\(^{81}\) Ibid., paras 8.02(b) (executive summary), 15.25(b). In Belgium, the minority shareholders can even ask the judge to declare such a decision null and void (see Kunz (n 17 above), s 17, n 59).
\(^{82}\) SCCLR Consultation Paper (n 12 above), paras 8.02(c) (executive summary), 15.25(c).
\(^{83}\) Ibid.
\(^{85}\) Ibid., para 6.5.
particular, an applicant would be required to seek leave from the court by close of pleadings to continue the action. In considering whether to grant leave the court would take account of all the circumstances. This is where the SCCLR's approach is different to that of the English Law Commission. The SCCLR's proposal has the advantage of allowing a shareholder to bring the substance of the complaint to the court for adjudication without the hurdle of a preliminary hearing on standing. However, it is also vulnerable to abuses by disgruntled shareholders. Thus, in this regard, the English Law Commission's proposal puts the courts back in charge by giving the courts the flexibility to allow cases to proceed in appropriate circumstances while giving the advisers, shareholders and the court the necessary guidance on matters which the court will take into account in deciding whether to grant leave.

The other main difference between the SCCLR's approach and that of the English Law Commission is that the Law Commission suggests that primary legislation is not required and that reform should be achieved by rules of court, whereas the SCCLR's proposed derivative action would be statutory. The proposal of the SCCLR to put derivative action on a statutory footing has the advantage of certainty, but does not give the court discretion to disallow any action in appropriate circumstances, as for example where there is a technical breach of duties by the director but it would not be in the best interest of the company for an action to be brought.

Nevertheless, the proposals of the SCCLR represent a breath of fresh air and would modernise derivative actions and empower shareholders in terms of seeking legal remedies for any wrong done to the company. The Government has announced plans to introduce legislation soon to implement the SCCLR's proposal.

(b) Unfair prejudice
Currently, under section 168A of the Companies Ordinance, a shareholder can petition the court for an appropriate order if the affairs of the company have been conducted in a manner which is unfairly prejudicial to the interests of the shareholders. The problem is that the concept of "unfair prejudice" is not defined in the Ordinance or judicially. This appears to be deliberate, because any definition would restrict the flexibility of such a concept. So the court generally looks at the alleged misconduct of the wrongdoing directors or shareholders in totality in the circumstances of each case. While it is reasonable to expect that expropriation can be regarded as unfairly prejudicial,

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86 Ibid., para 6.6.
88 Ibid.
it is tempting to put in as many allegations of misconduct as possible to bolster the claim and chances of success. This means that the pleadings can be very lengthy and claims can involve extensive evidence. This prolongs hearings and increases costs.

Section 168A has not been widely used by shareholders in listed companies where there is a market for the shares. The shareholders can always take the "Wall Street walk" (ie vote with their feet and sell their shares in the stock market), so unless there are very exceptional circumstances, they are unlikely to use the section. This section is usually used by shareholders in a quasi-partnership company where there is no available market for them to sell their shares. Furthermore, in a number of petitions involving quasi-partnership companies, the court has been reluctant to entertain unfair prejudice petitions where the respondents have made an offer to buy out the petitioners because the petitioners are expected to take up the offer as an alternative remedy. This may suggest that the court would be equally reluctant to entertain a petition by shareholders in a listed company where there is a market for the shareholders to exit. The SCCLR does not deal with the fundamental question of whether shareholders in listed companies should be allowed to use section 168A. The authors believe there is no good reason to deny shareholders in listed companies the remedies available under section 168A. The fact that shareholders in listed companies have a market to sell their shares does not mean that is an adequate remedy or protection. Where there exists major corporate malpractice (such as that witnessed recently in the United States), a large number of shareholders will all seek to sell their shares. This results in significant loss of value through the decline of the price of the shares, and results in losses for all shareholders. If the shareholders can petition under section 168A for a purchase order against the wrongdoers to purchase their shares at the market price before news of corporate malpractice comes to light, the shareholder can avoid their loss. Thus, it is proposed that section 168A be amended to make it clear that shareholders' right to petition should not be prejudiced by the fact that they are able to sell their shares through the stock exchange.

The SCCLR's proposal on section 168A is somewhat modest, merely saying that the court should be given power to award damages and costs to shareholders because this is not clear from the present legislation. However, it is arguable that the court already has such power since the court is entitled to "make such other order as it thinks fit". Curiously, it also proposes that

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91 Companies Ordinance, s 168A(2)(c). In Re a Company (No 005136 of 1986) [1987] BCLC 82, Hoffmann J was of the opinion that where the petition was in substance to protect the interests of the company, for example to restrain a transaction which was disadvantageous to the company, then the petitioner might be entitled to indemnity for cost from the company (at p 85a–c).
the court be given power to require controlling shareholders to buy out minorities. This is already a common order.\textsuperscript{92} The SCCLR also suggests that members of an overseas company should have a right to petition under section 168A, because arguably section 168A does not apply to overseas companies. This is important because a large number of companies listed in Hong Kong are incorporated abroad.

Unfortunately, the SCCLR has not dealt with the real problems with section 168A, which are the length of pleadings, trial and cost as mentioned above. These problems can only be resolved by proper guidelines on judicial case management. This is not addressed at all in the consultation paper.

Section 168A is modelled on section 459 of the UK Companies Act 1985,\textsuperscript{93} so again, the problems in England as regards section 459 are very similar to those in Hong Kong, except in Hong Kong the legal cost is likely to be much higher. The English Law Commission has published an impressive report on how case management can help to reduce cost.\textsuperscript{94} Rather surprisingly, this report was not referred to by the SCCLR. The Chief Justice's Working Party is considering ways to strengthen judicial case management.\textsuperscript{95} However, the modernisation of the derivative action may make section 168A even less relevant to shareholders in listed companies (though obviously section 168A would still be an important remedy for shareholders in non-listed companies).

In Continental Europe, there is no identical concept based on "unfair prejudice". A judge does not intervene in management decisions except in very extreme cases. Minority shareholders' protection is instead provided through various protective provisions on shareholders' special financial rights. For example, in Belgium the minority shareholders have a right to exercise a put option at the charge of controlling shareholders, thereby realising an exit.\textsuperscript{96} In France, a claim for dissolution of the company is possible; thereby, the value of the company is distributed as dividends.\textsuperscript{97} In several countries,
such as Germany, Finland, Spain and Sweden, minority shareholders are entitled to receive a minimum dividend (subject to certain conditions); thus, the controlling shareholders cannot “starve out” the small owners. In others, such as Luxemburg, a share without voting rights must be combined with a higher dividend than a share with voting rights. In general, European laws do not allow an expropriation of shareholders.

(c) Personal rights

Expropriation, which is a wrong to the company, cannot be regarded as a wrong to members personally. Where the wrongdoers are directors, it is not well settled whether a member can bring a personal action against the wrongdoing directors for breach of duties, because directors owe their duties to the company only in very limited circumstances, the precise scope of which is not well defined. Neither can a shareholder sue the wrongdoing directors for loss in the value of his shares, because the damage is to the company and the shareholder’s loss is only consequential to the company’s damage. Also, where the right is conferred on him in his capacity as an outsider, it is not clear whether he can enforce such right in a personal action. The SCCLR proposes that it should be made clear that individual members should have the right to enforce all rights in the memorandum and articles in a personal action. This is now in the Companies (Amendment) (No 2) Bill 2002 which is being considered by the Legislative Council. This proposal will remove the current uncertainty surrounding shareholders’ right to enforce personal rights. But until the rule that expropriation is a wrong to the company is changed, shareholders remain unable to bring a personal action against expropriation.

98 See Art 254, s 7 of the German Company Law (s 254 Aktiengesetz); M. Stecher, “Germany”, in AIJA (n 61 above), pp 86-94.
99 See P. Tenhonen, “Finland”, in AIJA (n 61 above), pp 57-64.
100 See Art 91 of the Spanish Company Law (Ley de Sociedades Anonimas); C. Armero Montes, “Spain”, in AIJA (n 61 above), p 191, 199, n 36.
102 See Art 44 of the Company Law of Luxembourg (Lois Luxembourgeoises sur les sociétés); T. Loesch, “Luxembourg”, in Maitland-Waller (n 31 above), pp 355-360.
103 See, for example, MacDougall v Gardiner (1875) 1 Ch D 13, p 25; Edwards v Halliwell [1950] 2 All ER 1064, p 1066g-h; Prudential Assurance Co. Ltd v Newman Industries Ltd (No 2) [1982] Ch 204, p 224A-D. See also Goo (n 93 above), p 10.
104 See Goo (n 93 above), ch 3, para 3.2(g). Beck ((1974) 52 Can Bar Rev 159, pp 171-172) suggested that any breach of director’s duty should give rise to a personal action.
105 Prudential Assurance (No 2) (n 103 above), p 223.
106 See Goo (n 93 above), p 11.
107 See clause 9 of the Companies (Amendment) Bill 2002.
Other Associated Problems

1 Voting by Poll
Although the shareholders may vote in the general meeting for their candidates to the position of directorship, the fact that the investing public is invariably in the minority (as the minimum requirement for the public float is only 25 per cent) means that often they do not have enough votes to succeed. In the case of related party transactions, where interested shareholders and connected persons are not allowed to vote, the minority shareholders may have stronger influence over the outcome of the voting. However, it has been suggested that the voting process in Hong Kong by show of hands favours the controlling shareholders. Thus, although the Listing Rules require independent shareholders’ approval for certain related party transactions, voting by show of hands renders this requirement ineffective.\textsuperscript{108}

In Hong Kong, at any general meeting a resolution put to the vote of the meeting is usually decided on a show of hands unless a poll (before or on the declaration of the result of the show of hands) is demanded.\textsuperscript{109} Thus, it depends on how many shareholders turn up at the general meeting to vote. Apparently, in practice, what happens is that the votes of the public are nearly always overwhelmed by the hands of employee shareholders (who are not directors and who may have received a small number of shares as a reward for being good employees), who receive a script and instructions from the management or controlling shareholders on how to vote.\textsuperscript{110} As for the public, most hold their shares in the name of the clearing company, Hong Kong Securities Clearing Company (Nominees) Ltd (HKSCC Nominees) under the Central Clearing and Settlements System (CCASS).\textsuperscript{111} Although it is possible to withdraw the stock from CCASS and register it in one’s own name, this is not usually done because it is expensive, and in any case it makes scriptless settlements rather pointless.\textsuperscript{112} According to one commentator:

“Before a meeting is held, CCASS seeks instructions from its participants and aggregates all the votes, then forwards them to the company by filling in a proxy form. Often they will send someone to actually attend the

\textsuperscript{109} Companies Ordinance, First Sch, Table A, Art 60.
\textsuperscript{110} Webb (n 108 above).
\textsuperscript{111} Ibid. Often through their bank, broker or custodian, as that is how they received the shares when they bought them, and they have to be in the system to settle a sale. But since May 1998, it has also been possible to hold stock directly in the CCASS system as an “investor participant”. The fees are lower than most brokers will charge and there is no risk of the broker running away with the stock.
\textsuperscript{112} Ibid.
meeting, but that person can only cast one vote on a show of hands, so they make a single vote based on the majority of instructions received.\footnote{Ibid. The SFC is currently studying the problems to which share ownership under CCASS gives rise and plans to introduce legislative changes after public consultation to deal with the problems, See Yeung (n 89 above).}

Thus, unless there is a poll where each share has one vote, the CCASS, who represents the public, is in the minority. The shareholders' right to demand a poll is provided for in the articles of association. Typically, the articles provide that a poll can be demanded: (a) by the chairman; or (b) by at least two members present in person or by proxy; or (c) by any member or members present in person or by proxy and representing not less than one-tenth of the total voting rights of all the members having the right to vote at the meeting; or (d) by a member or members holding one-tenth of the paid-up capital conferring a right to vote.\footnote{Companies Ordinance, First Sch, Table A, Art 60.}

Section 114D of the Companies Ordinance, which is similar to section 373 of the English Companies Act 1985, provides that any provision contained in a company's article is void in so far as it would:

1. exclude the right to demand a poll at a general meeting on any question other than the election of the chairman of the meeting or the adjournment of the meeting; or
2. require more persons to demand a poll on any such question than:
   (a) five members having the right to vote at the meeting; or
   (b) a member or members representing not less than one-tenth of the total voting rights of all the members having the right to vote at the meeting; or
   (c) a member or members holding one-tenth of the paid up capital conferring a right to vote.

Furthermore, a proxy has the same right as the members he represents to demand a poll.\footnote{Ibid., s 114D(2).}

If a poll is demanded, CCASS will have more than one vote, and need not use all the votes or cast all the votes it uses in the same way.\footnote{Ibid., s 114E.} This will enable the CCASS to cast votes in a manner which reflects the respective interests of the various shareholders participating in the system. However, CCASS usually does not demand a poll, even if it has received voting...
instructions in respect of shares totalling more than 10 per cent of the votes. As one author has noted:

"You would have to make a special arrangement to get CCASS to demand a poll, in respect of your shareholding alone, which would have to be pretty big unless at least two other shareholders at the meeting go with CCASS."

It has been suggested that one simple solution is for the Listing Rules to require that all votes in meetings of shareholders be held on a poll. As one commentator argued, "[m]eetings would take longer, but be far fairer, as votes sent through CCASS would be given their full voting weight based on shares held and not hands raised. As a consequence, controlling shareholders would think harder before trying to rip off minorities." The HKEx has proposed to amend the Listing Rules to require voting by poll for connected transactions and all resolutions requiring independent shareholders' approval. It has also been suggested that CCASS should be required to use its votes in a manner which reflects the instructions from its participants.

2 Absence of Class Action and Contingency Fee

As mentioned, the obscurity of the common law on derivative action coupled with the high cost of litigation in Hong Kong has prevented shareholders from being more actively involved in holding controlling shareholders accountable for any wrongdoing. It has sometimes been suggested that as a way of encouraging and assisting legal action by shareholders, Hong Kong should adopt the US style class action and contingency fee system. A class action in the US is essentially a personal action brought by shareholders as a group (or in other words, an action by shareholders as a group for harms to their interests directly as owners of the shares). The current procedure in Hong Kong is not designed to cater for group litigation. Shareholders in Hong Kong

117 Webb (n 108 above).
118 Ibid.
119 Ibid.
120 Ibid.
121 HKEx Consultation Paper (n 29 above), Part B, paras 1.1–1.6.
122 Webb (n 108 above).
123 The Chairman of the SFC, Mr Andrew Sheng, has reportedly said that the absence of a US-style class action contingency fee system was another weakness of Hong Kong's corporate governance: see Yeung (n 49 above). Mr David Webb, a shareholder activist in Hong Kong, has called for the introduction of the US system: see Yeung (n 89 above).
can bring representative action to enforce shareholders' personal rights, but it is only suitable for a relatively small number of parties closely concerned in the same proceedings, and inadequate for dealing with large-scale multi-party situations. The Chief Justice's Working Party is currently considering whether a group litigation scheme should be adopted.

Apart from the inadequacy of representative action as a main way of facilitating group shareholder litigation, representative action is rarely used because, as discussed above, it appears that expropriation cannot be a subject of a personal action. Thus, until the law is reformed to allow personal action to redress a wrong done to the company and breach of directors' duties, the introduction of a group litigation scheme or class action would not help.

As for the contingency fee system in the United States, it is well known that plaintiffs in a civil action pay their own legal fees regardless of the outcome, but in a class action, attorneys' fees can come from the class if there is a judgment or settlement. However, attorneys can be paid on a contingency basis, that is plaintiffs can bring an action without paying fees if the attorney is willing to bet on a recovery. There are attorneys who specialise in such suits who are willing to fund the class action and this has helped many shareholders to bring class actions against the wrongdoing directors or managers. We do not have a contingency fee system in Hong Kong. The debate as to whether we should have one has been around for a long time and is ongoing. In the United States, while the contingency fee system has made it possible for attorneys who are willing to fund the litigation to help solve the collective action problem, it has also encouraged attorneys to bring "strike suits" only for the fees. In some instances, attorneys have been able to control the litigation by forcing settlements with small recoveries and large fees from the corporation and avoiding the burdens and costs of litigation with extensive discovery.

3 Access to Information
To a large extent, the shareholders' ability to monitor by legal action the management against expropriation or other wrongdoing depends on whether they have sufficient information about the transactions complained of.

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125 See n 95 above, s 385.
126 Ibid., p 18 (s 77 of the executive summary), and ss 391–402 of the main text.
127 Pinto (n 124 above), p 276.
128 Ibid., p 276.
Currently, while they have rights of access to certain information, the company's accounts, books or papers can be inspected only if authorised by directors or a general meeting. It is the lack of access to books and accounts that disadvantages the shareholders.

This list of information available to shareholders is relatively short in comparison with the standards applied not only in the United States, but also in Continental Europe. In particular, minority shareholders are usually interested in the financial rights of directors; therefore, shareholders can seek information concerning the salaries, fees and bonus payments paid to directors as, for example, in France and Luxembourg. The shareholders, however, do not have direct access to the books, but the management is obliged to disclose appropriate information.

It is important to strike a balance between empowering minority shareholders and preventing harassment of the company by certain shareholders. Thus, the SCCLR proposes that shareholders should have access to information by application to the court. They must satisfy the court that they are acting in good faith and inspection is for a proper purpose. Only authorised persons (eg solicitors and auditors) can inspect and make copies of documents inspected under court order, and they must not disclose information obtained except to relevant authorities (eg the court). This appears to be a very sensible proposal which will strengthen the shareholders' monitoring power on the one hand and protect business confidentiality on the other. The HKICS is also in favour of this proposal.

4 Fiduciary Duties and the Duty of Care and Skill
Currently, directors owe fiduciary duties to the company to act in the best interest of the company, and not to profit from their position as directors, nor place themselves in a position where their duties to the company may conflict with their personal interest. They should not exercise their powers for improper purposes, nor fetter the exercise of their powers. They must also exercise care

130 For example, to inspect the register of debenture holders (Companies Ordinance, s 74A), register of charges (ibid., s 83), register of directors and secretaries (ibid., s 158(7)), minute books of general meeting (ibid., s 120), register of members (ibid., s 95) and management contracts at general meetings (ibid., s 162A) and to ask for a copy of the memorandum and articles (ibid., s 26). Profit and loss statement, balance sheet and auditor's report are sent to members before the general meeting (ibid., s 129G). The register of interests in shares is open to inspection by the public (Securities (Disclosure of Interests) Ordinance, s 27).


132 See P. Schleimer, "Luxembourg", in AIJA (n 61 above), pp 137–144.

133 SCCLR Consultation Paper (n 12 above), para 18.05.
and skill in the discharge of their duties to the company. There is no statutory formulation of the business judgment rule in Hong Kong, although the court will not question the business judgment of the directors and will not interfere with the directors’ decision if there is no evidence of bad faith.

To cause the company to enter into expropriation transactions in favour of directors themselves or the controlling shareholders is potentially a breach of directors’ duties. However, as directors’ fiduciary duties and duty of care and skill have been developed over a century entirely by judges on a case-by-case basis, a process of judicial decisions setting precedents and applying or distinguishing them in various circumstances, there are inevitably uncertainties and sometimes inconsistencies. For example, how do we decide whether the directors have exercised their power for a proper purpose in a particular situation? When can directors profit from their position? If the director enters into a transaction with the company, can the transaction be ratified by the general meeting? As mentioned above, the common law rule prohibiting directors from entering into contracts with the company is now of course subject to section 162 of the Companies Ordinance which allows directors to enter into such contracts if proper disclosure of interest has been made and approval of the board of directors has been obtained. This makes it possible for directors who are also controlling shareholders to abuse their power. On the other hand, the common law duty of care and skill is often applied with difficulty. When will a director be held negligent, since the level of care and skill to be expected varies with the ability, experience and qualification of the director? When can he delegate certain tasks and duties to others? It is not entirely satisfactory if directors do not know what exactly is expected of them and how to behave. Research has shown that many directors do not

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134 See for example Howard Smith Ltd v Ampol Petroleum Ltd [1974] AC 821, PC (allotment of shares to enable takeovers), Hogg v Cramphorn Ltd [1967] Ch 254 (allotment of shares to prevent takeovers) where power was held to have been improperly exercised. Contrast Teck Corporation v Millar (1972) 33 DLR (3d) 288, British Columbia and Mills v Mills (1938) 60 CLR 150, Australia where manipulation of voting power through allotment of shares was held valid.

135 See for example Regal (Hastings) Ltd (n 19 above) (directors joined in transaction so that company could have the contract, held accountable); Cook v Deeks (n 23 above) (formed new company to take contract from third party, held accountable); Industrial Development Consultants Ltd v Cooke (1972) 1 WLR 443 (resigned to take contract from third party, held accountable). Contrast Island Export Finance Ltd v Umunna (1986) BCLC 460 (resigned because of personal reasons, then took contract from third party, held valid); Kishimoto Sandyo Co. Ltd v Oba (1986) 2 HKC 260 (Oba resigned and then pursued the possibility of supplying the same equipment for the mass production contract for which he was negotiating for the company before his resignation: held no breach of fiduciary duty as the mass production contract was not a maturing business opportunity).

136 See for example Regal (Hastings) Ltd (n 19 above) (obiter: directors could have ratified the transaction as shareholders); Cook v Deeks (n 23 above) (ratification by majority as shareholders was not valid).

137 See the test in Re City Equitable Fire Insurance Co. Ltd [1925] Ch 407. Contrast the more demanding test in Daniels v Anderson (1995) 16 ACSR 607, NSW CA.
know what duties they owe in law to the company.\textsuperscript{139} And many lawyers find it difficult to advise their clients whether certain proposed conduct or transactions may be a breach of directors' duties. Thus, there has been a debate in the United Kingdom and Hong Kong as to whether there should be a clear statutory statement of duties so that directors know their position.

Surprisingly, the SCCLR in the consultation paper is of the view that the current law on fiduciary duties and standards of care and skill is generally acceptable and that there is no need to have a statutory statement of duties. We find this difficult to understand. The courts in the United Kingdom and Hong Kong have for many years struggled with the difficulties that arose from case law on directors' duties which in the United Kingdom had prompted the question of codification to be considered twice. The state of the case law is anything but acceptable. Although the SCCLR points out in the consultation paper that the Company Law Review Steering Group (CLRSG) in the United Kingdom has proposed a statutory restatement, and that there is general support for it, it did not think that such a restatement would work in Hong Kong. It points out that it would not be possible for all duties to be properly encapsulated in the law where the breach depends on the complexities of the facts.\textsuperscript{140} And such a statement would be regarded as exhaustive. This argument is true only if full codification is adopted. If partial codification is adopted, whereby the statute would provide the main, settled duties, while the general law would continue to apply in those areas not covered by statute, the statutory statement would not be exhaustive, and the law would continue to develop.\textsuperscript{141}

In contrast, the UK Law Commission and CLRSG have seen the benefits of partial codification of duties.\textsuperscript{142} First, it will provide greater clarity to what is expected of directors and make the law more accessible. This will in turn help to improve standards of governance. Second, it will enable defects in the present law to be corrected where it no longer corresponds to accepted norms of modern business practice. Third, it addresses the question of "scope", i.e. in whose interests should companies be run? The parliamentary draftsmen in the United Kingdom have also supported such a move by confirming that such a statement can be effectively drafted in an accessible form which is also fit for the statute book.

\textsuperscript{139} Abdual Majid, Low Chee Keong and Krishnan Arjunan, "Company Directors' Perceptions of their Responsibilities and Duties: Hong Kong Survey" (1998) 28 HKILJ 60.
\textsuperscript{140} SCCLR Consultation Paper (n 12 above), para 6.13.
\textsuperscript{141} See for example the arguments in Law Commission and Scottish Law Commission, Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties (Law Com No 261) (London: Stationery Office, 1999) paras 4.4-4.9, 4.22, 4.31-4.43.
\textsuperscript{142} Ibid., Part IV; The Company Law Review Steering Group, Modern Company Law for a Competitive Economy: Final Report (July 2001), paras 1.21-1.22, 1.54, 2.20, 3.5-3.11.
Conclusion

Controlling shareholders and the problems associated with them are significant features of Hong Kong's financial markets and are unlikely to change in the short term. Some people have suggested increasing the requirement for minimum public floats (currently 25 per cent of shares) in listed companies as a way of reducing the prevalence of controlling shareholders.\textsuperscript{143} The authors respectfully disagree, as this effectively requires the controlling shareholders to give up more of their share of wealth in a listed company in return for the privilege of listing.\textsuperscript{144} This can be seen as a reverse expropriation by the public. As explained in this article, there are other ways of dealing with the problems of dominant shareholding. What is needed is tighter control, as proposed by the SCCLR's and HKEx's consultation papers, both of which are broadly in line with international standards and the laws of many European countries. Simple reform of the process of voting, the process of nomination and appointment of directors, of related party transactions as well as a clearer scope of directors' duties, improvement of legal remedies and access to company books would all help to prevent unfair expropriation and enhance Hong Kong's standards of corporate governance.

\textsuperscript{143} Low Chee Keong, \textit{Hong Kong Lawyer}, Apr 2000, p 32 suggests that the minimum free float should initially be lifted to at least 30\% with a higher free float of 50\% for smaller capitalised companies and that this distinction be gradually phased out with a free float of 50\% ultimately being common for all companies.

\textsuperscript{144} Minimum free floating requirements are usually not stated in European laws; however, there is a possibility for a large controlling shareholder to place a request with the stock exchange to delist the shares if regular trading no longer takes place.