MAYER | BROWN

9 January, 2024

Legal Update

Unravelling the Legal Landscape: Key Highlights of Company Litigation Developments in Hong Kong in 2023

Here we present a concise summary of significant cases and developments in company litigation in Hong Kong in 2023.

Highlights include:

1. **Subject company's participation in unfair prejudice proceedings**: The Court once again confirmed its "distaste" for a subject company seeking to enter the arena in unfair prejudice proceedings between shareholders.
2. **New Practice Direction 3.4**: The Court set out various standard case management directions for the conduct of unfair prejudice and just and equitable winding-up proceedings, reflecting its active case management role in such proceedings.
3. **Rule against reflective loss**: The Court of Appeal explained the rule against reflective loss and considered a recent UK Supreme Court decision.
4. **Principles of unfair prejudice petitions**: The Companies Court stressed the need to properly consider whether the circumstances show any equitable constraint on the exercise of strict legal rights and ordered a non-shareholder to buy out the petitioners' shares.
5. **Valuation in unfair prejudice petitions**: The Companies Court clarified its approach to valuing shares in unfair prejudice petitions, specifically addressing deduction of notional expenses in the valuation of shares of property-holding companies.
6. **Implication of exclusive jurisdiction clause in insolvency**: It is now clear that where there is an exclusive jurisdiction clause, the Court will generally hold the parties to their bargain and stay or dismiss the winding-up petition. But it's not as clear whether the same approach applies to arbitration agreements.

Subject Company's Active Participation in an Unfair Prejudice Petition Is Generally Not Allowed:

One of the key protections for minority shareholders is the right to present an unfair prejudice petition, usually against the majority shareholder-director. The subject company itself needs to be added as a respondent as a nominal party for, inter alia, seeking discovery and obtaining an order binding on it. As the dispute is essentially between, at least, two camps of shareholders, the company itself is usually separately represented and takes a neutral stance as to the dispute itself.

In ***Glory Sky Asia Limited & Ors v. Koo Kam Pui & Anor*** [2023] HKCFI 1849, the minority shareholders (holding less than 10% of the entire shareholding) presented an unfair prejudice petition against the director and the single largest shareholder in the company and the company itself. The company itself was separately represented but intended to actively participate in the proceedings to respond to some of the allegations made by the petitioners. The petitioners applied for an order requiring the company not to take any steps in the petition other than providing discovery and attending hearings at which the Court considered reliefs to be granted in respect of the petition.

Allowing the petitioners' application, the Honourable Mr Justice Ng held that:

- The starting point is that generally there is no justification for the company in unfair prejudice proceedings essentially involving disputes between shareholders to fully and actively participate in the petition. This is described as "*a sort of rebuttable distaste for such participation and expenditure and initial scepticism as to its necessity or expediency*".
- The company intending to actively participate should therefore point to good reasons which render it necessary or expedient for it to do so in the interests of the company as a whole, with evidence. This is a heavy burden.
- The company's argument that the petitioners made allegations against the company itself was unfounded as those allegations, properly read in context, were against the director and largest shareholder, not freestanding allegations against the company.

This case serves as a reminder that it is difficult to satisfy the Court that it is necessary or expedient for the company itself to participate in unfair prejudice proceedings actively.

This is also reflected in paragraph 2 of the new Practice Direction 3.4 which states: *"[t]he company named in the petition (Company) is a nominal respondent and, therefore, is not expected to take any step in the proceedings other than for the purposes of (a) applying for a validation order, (b) making discovery, and (c) attending the hearing at which the Court is to consider what substantive relief should be granted and such relief may have an impact on the Company."*

New Standard Directions for Case Management for Unfair Prejudice and Just and Equitable Winding-Up Proceedings

Unfair prejudice and just and equitable winding-up proceedings are often disputes between shareholders. Further, the Securities and Futures Commission (SFC) is also entitled to bring such proceedings under limited circumstances set out in sections 212 and 214 of the Securities and Futures Ordinance (Cap. 571).

In 2023, besides updating Practice Direction 3.1 (Bankruptcy and Winding-Up Proceedings) – which is more applicable to insolvency based petitions – the Court also updated Practice Direction 3.3 for case management of unfair prejudice and just and equitable winding-up proceedings.

In short, the updated Practice Direction 3.3 sets out standard case management directions in respect of, *inter alia*:

1. The first directions hearing before a Judge, including the filing of skeleton arguments and hearing bundle.
2. Just and equitable winding up, including requiring respondents to inform the petitioner whether liability is contested prior to the call-over hearing before a Master. If so, the Court would normally order pleadings to be filed and the parties should consider adopting standard directions set out in Appendix A to this Practice Directions – which

include comprehensive directions from the Points of Claim, Points of Defence, Discovery, Case Management Conference, Pre-Trial Review and Trial.

3. Unfair prejudice petition and a petition by the SFC, including requiring the respondents to inform the petitioner whether liability is contested before the first directions before the Judge. If not, they should confirm whether they agree to dispose of the petition by way of a summary procedure known as Carecraft procedure; if so, the Court would again likely order pleadings to be filed and the parties should consider adopting the standard directions in Appendix A.
4. Expert evidence, including requiring the parties to consider adopting standard directions in Appendix B to the updated Practice Directions on expert directions for valuation of the fair market value of the subject company.

This new Practice Direction provides a clear framework for the conduct of unfair prejudice and just and equitable winding-up proceedings. It is clear that the Court expects respondents to make it clear how far they contest "liability"; and expect the first directions hearing before a Judge to fully set out case management directions up to trial if possible, which can help avoid parties' delay.

Court of Appeal Explains Law on Reflective Loss

The rule against a claim for reflective loss has long been a bar against aggrieved shareholders who want to pursue wrongdoers causing losses to the company and their losses are reflected by the former (i.e. a diminution in the value of shareholding or distribution).

In 2020, the UK Supreme Court fully reviewed the rule against reflective loss in ***Sevilleja Garcia v. Marex Financial Ltd*** [2020] UKSC 31. The majority held that:

- Rationale of the rule lies in the rule in *Foss v Harbottle*, i.e. the only party who can seek relief for an injury done to a company is the company itself.
- Avoidance of double recovery does not justify this rule.

In ***Power Securities Co Ltd v. Sin Kwok Lam*** [2023] HKCA 594, Sin alleged that one Mr Tang, who exercised de facto control of Power Securities, engaged in a plan to acquire majority control of First Credit Finance Group Ltd which was listed on GEM. At the time, Sin indirectly held shares in First Credit via two companies, one of which had opened a margin securities trading account with First Credit. No agreement was reached.

Sin further alleged that the share price of First Credit fell in September 2017 as a result of a conspiracy to drive down the share price of First Credit by way of illegal market manipulation, so as to enable Mr Tang (through his nominee) to acquire control over First Credit. As a result of the price drop, there was a margin shortfall and Power Securities was sued for the debit balance remaining after liquidating certain pledged shares. In March 2018, Sin sold his shares in the two companies holding shares in First Credit.

Sin counterclaimed for his alleged loss as a result of the alleged conspiracy and also brought a separate claim based on this. Affirming the decision to strike out Sin's counterclaim and claim, the Honourable Madam Justice Yuen, Justice of Appeal held that:

1. The Court of Final Appeal pronounced on the reflective loss rule in Hong Kong in ***Waddington Ltd v. Chan Chun Hoo*** (2008) 11 HKCFAR 370 and Basab Inc v Superb Glory Holdings Ltd (2017) 20 HKCFAR 384 by referring to the avoidance of double recovery as the rationale. In this regard, her Ladyship held that the Court of Appeal is bound by ***Waddington.***

2. However, the CFA in ***Waddington*** also held that "as a matter of principle" a shareholder cannot claim for loss which was merely reflective of the loss suffered by the company. The focus is on the nature of the loss.
3. In this case, Sin's alleged loss is the diminution in value of the shares of the two companies holding First Credit's shares allegedly caused by the conspiracy. The nature of such claim is clearly reflective loss.
4. While Sin sold his shares in the two companies in March 2018, this sale does not alter the nature of his reflective loss.

Companies Court Calls for Proper Consideration of the Applicability of Unfair Prejudice Principles and Imposes Buy-Out Order against a Non-Shareholder

In ***Re Promising Securities Company Limited*** [2023] HKCFI 3367, Promising Securities provided brokerage services for securities traded on the Stock Exchange of Hong Kong, with the Securities and Futures Commission's Type 1 licence for dealing in securities.

There were two camps of shareholders, including the petitioners and the 1st petitioner's late wife on the one hand, and the respondents on the other hand. The 6th respondent, the 2nd respondent's daughter, was not a shareholder but was involved in the alleged unfairly prejudicial conduct.

The petitioners alleged that Promising Securities was a quasi-partnership which should operate on the basis of a "Fundamental Relationship" of mutual trust and confidence between the two camps and the "Fundamental Understanding" that, inter alia, the two camps would have equal share in management and neither of them would be excluded from management.

The petitioners alleged that Promising Securities' affairs were conducted in a way that was unfairly prejudicial to them, including excluding them from management and purporting to allot shares in order to dilute their shareholdings.

Given that similar allegations are commonly advanced, the Honourable Madam Justice Linda Chan took the opportunity to stress:

- In the context of a just and equitable petition or an unfair prejudice petition, the petitioner needs to show that the respondents have acted in breach of (1) what the parties agreed in contact (e.g., the Articles of Association) such that there was a breach of his legal rights or (2) what the parties have accepted to be the practice or the manner in which the affairs of the company should be conducted, even though such practice or manner is inconsistent with the terms of the contract or articles.
- Where (2) is relied on, the Court expects the petitioner to show that there has been a relatively long period of acceptance of the practice in question by the shareholders concerned.
- Very often, the parties and the legal representatives do not really appreciate the true principles and seem to think that by calling a company a quasi-partnership, the petitioner can complain about the conduct of the respondents even though the conduct did not involve any breach of legal rights or accepted practice and there was no equitable constraint on the exercise of legal rights on the respondents.

In this case, Her Ladyship was satisfied that the Fundamental Relationship and the Fundamental Understanding apply to Promising Securities; and the respondents unfairly prejudiced the

petitioners' camp by excluding them from management and proposing to allot shares to dilute their shareholding from 28% to 4.9%.

As the petitioners had settled the matter with the 1st, 3rd to 5th respondents and the 7th respondent (Promising Securities) is a nominal respondent, her Ladyship ordered the 2nd respondent and the 6th respondent (a non-member) to buy out the petitioners' shares in Promising Securities.

In this regard, sections 724 to 726 of the Companies Ordinance (Cap.622) provide a wide and flexible remedy; and non-members who are alleged to have been responsible and made parties to the petition can be held primarily or secondarily liable to buy the petitioners' shares.

Companies Court Clarifies Share Valuation in Unfair Prejudice Petitions

In ***Kuen-fai Stephen Luk v. Criteria Holdings Ltd and Others [2023] HKCFI 2268,*** the Honourable Madam Justice Linda Chan clarified the approach of the Court on the valuation of shares in the context of buy-out reliefs arising from unfair prejudice petitions. In particular, the case addressed the question of whether and to what extent notional expenses should be deducted when assessing the fair market value of shares of a property-holding company.

The dispute involved three groups of siblings, namely the Stephen Parties, the Simon Parties, and the three Luk Brothers, who were embroiled in a disagreement over the affairs of two family companies and their subsidiaries, which were primarily property-holding companies. In the course of the proceedings, the parties agreed for the three Luk Brothers to buy out the Stephen Parties' shares at a valuation determined by the court, with the assistance of a single joint expert.

The judge examined the principles governing the proper approach to valuing a company in the context of an unfair prejudice petition. The court has broad discretion to act in a manner that is fair and equitable between the parties, encompassing the choice of valuation methodology, assumptions and directions. When a single joint expert is appointed to determine the valuation, the court is generally hesitant to intervene on matters of opinion.

After accepting the expert's opinion that the property holding companies should be valued using an asset-based valuation approach rather than a market-based valuation approach, the judge ruled on the issue of whether the realisation costs or expenses associated with a hypothetical sale of the real properties should be deducted in the valuation exercise. Taking into account the companies' value was assessed on the assumption that all real properties would be sold, Her Ladyship concluded that it would be appropriate to deduct the notional expenses the companies would incur in such a sale.

The judgment provides clarity on the valuation of shares in unfair prejudice petitions, particularly in relation to the deduction of notional expenses associated with a hypothetical sale of real properties held by a company and offers valuable guidance to the Hong Kong courts for future cases involving similar valuation considerations.

Interplay between Winding-Up Proceedings and Jurisdiction and Arbitration Clauses

While a creditor commencing winding-up proceedings is to enforce his class right which affects all creditors, how far a creditor can do so where there is an exclusive jurisdiction clause (EJC) or arbitration agreement in the underlying contract from which the debt arises is hotly debated.

In its landmark decision in ***Guy Kwok-Hung Lam v. Tor Asia Credit Master Fund LP*** [2023] HKCFA 9, the Court of Final Appeal importantly held that in the ordinary case of an EJC, absent countervailing factors such as the risk of insolvency affecting third parties and a dispute that borders on the frivolous or abuse of process, the petitioner and the debtor ought to be held to their contract (known as the "Guy Lam Approach"). In other words, the traditional approach which requires the debtor to demonstrate a bona fide defence on substantial grounds in order to defeat a bankruptcy petition does not apply where there is an EJC.

There is no doubt that the Guy Lam Approach applies to both bankruptcy and winding-up proceedings. However, an important question then is whether the Guy Lam Approach also applies to winding-up proceedings involving an arbitration clause.

In this regard, there are inconsistent decisions in the Court of First Instance by company judges:-

1. On the one hand, in ***Re Simplicity & Vogue Retailing (HK) Co., Ltd*** [2023] HKCFI 1443 and in ***Re NT Pharma International Co., Ltd*** [2023] HKCFI 1623, Linda Chan J held that the Guy Lam Approach does not apply to arbitration clauses and made winding-up orders against both companies.
2. However, in ***Re Shandong Chenming Paper Holdings Limited*** [2023] HKCFI 2065, Harris J held that the Guy Lam Approach does apply to arbitration clauses. In a footnote of the judgment, Harris J expressly referred to Re Simplicity and indicated his agreement to the submission by the company that Linda Chan J's ruling was wrong as it is clear that the Court of Final Appeal's view was that the Guy Lam Approach should be taken to the application of an EJC and an arbitration clause.

Leave to appeal to the Court of Appeal was granted in Re Shandong Chenming Paper Holdings Limited and Re Simplicity & Vogue.

On this inconsistent point of law, guidance and clarification from the Court of Appeal are much needed and keenly awaited.

In summary, 2023 witnessed various notable developments in company litigation, shedding light on aspects of shareholder disputes, management autonomy, jurisdictional considerations and such.

These rulings contribute to the on-going evolution of corporate law and serve as valuable precedents for future application of the legal principles.

For more information about the topics raised in this Legal Update, please contact any of the following lawyers.

Vincent Law
+852 2843 2479
vincent.law@mayerbrown.com

Johnson Ng
+852 2843 4248
johnson.ng@mayerbrown.com

Emily Chen
+852 2843 4272
emily.chen@mayerbrown.com

To learn more about our Litigation & Dispute Resolution practice, please contact any of the following lawyers.

Terence Tung
+852 2843 4428
terence.tung@mayerbrown.com

Geoffrey Chan
+852 2843 4200
geoffrey.chan@mayerbrown.com

Billy Lam
+852 2843 4392
billy.lam@mayerbrown.com

Nancy Leung
+852 2843 4510
nancy.leung@mayerbrown.com

Vincent Law
+852 2843 2479
vincent.law@mayerbrown.com

Alan Linning
+852 2843 2231
alan.linning@mayerbrown.com

Raymond Chan
+852 2843 4394
raymond.chan@mayerbrown.com

Wilson Fung
+852 2843 2404
wilson.fung@mayerbrown.com

Raymond Yang
+852 2843 2295
raymond.yang@mayerbrown.com

Mayer Brown is an international law firm, positioned to represent the world's major corporations, funds and financial institutions in their most important and complex transactions and disputes.

Please visit www.mayerbrown.com for comprehensive contact information for all our offices.

Any tax advice expressed above by Mayer Brown LLP was not intended or written to be used, and cannot be used, by any taxpayer to avoid U.S. federal tax penalties. If such advice was written or used to support the promotion or marketing of the matter addressed above, then each offeree should seek advice from an independent tax advisor.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek legal advice before taking any action with respect to the matters discussed herein.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England & Wales), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) and non-legal service providers, which provide consultancy services (collectively, the "Mayer Brown Practices"). The Mayer Brown Practices are established in various jurisdictions and may be a legal person or a partnership. PK Wong & Nair LLC ("PKWN") is the constituent Singapore law practice of our licensed joint law venture in Singapore, Mayer Brown PK Wong & Nair Pte. Ltd. Details of the individual Mayer Brown Practices and PKWN can be found in the Legal Notices section of our website.

"Mayer Brown" and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2024 Mayer Brown. All rights reserved.

Attorney Advertising. Prior results do not guarantee a similar outcome.