

Cambridge University Press

978-1-107-19419-9 — Alternative Dispute Resolution of Shareholder Disputes in Hong Kong

Ida Kwan Lun Mak

Excerpt

[More Information](#)

PART I

Introduction, Overview and Methodology

Introduction

1.1 Resolution of Shareholder Disputes in a Small Private Company

The majority of companies registered in the Hong Kong Company Registry are, in fact, closely held corporations whose shares are not publicly traded.¹ Clearly, these small quasi-partnership types of private limited companies are playing an important role in the Hong Kong economy, as about 60 per cent of the Hong Kong population is employed by these entities.² Although the strength of personal and/or family ties offers real benefits for shareholders to work closely together in a privately owned business, minority shareholders in particular are vulnerable to the opportunistic conduct of majority shareholders. Therefore, minority shareholder disputes are of concern primarily to private companies with management ownership concentrated in the hands of a small group of family members.

In general, the family business model can be viewed as the ‘power-house’ that not only generates wealth and economic well-being, but also strengthens the intimacy of family ties that support the ongoing operation of a family business.³ These blood ties may consequently produce superior performance of a business enterprise.⁴ However, the informal organizational structure of small private companies, coupled with the doctrine of majority rules, makes it possible for those who control the majority of shares in the company to employ a variety of squeeze-out techniques

¹ Statistics Relating to the Number of Local Companies Incorporated in Hong Kong. Available at www.cr.gov.hk/en/statistics/statistics_02.htm (Accessed 10 August 2016).

² *Corporate Governance Review by the Standard Committee on Company Law Reform: A Consultation Paper made in Phase I of the Review* (Printing Department, 2001) at para. 1.04.

³ Grant Gordon and Nigel Nicholson, *Family Wars: Classic Conflicts in Family Business and How to Deal with Them* (London: Kogan Page, 2008).

⁴ Richard Milne, ‘Blood Ties Serve Business Well During the Crisis’, *Financial Times*, 28 December 2009, 15 and Benjamin Means, ‘NonMarket Values in Family Business’, *William & Mary Law Review*, 54 (2013), 1185–1250 at 1230.

(such as exclusion from management, dilution of minority shareholding with an improper motive, excessive remuneration, misapplication of company assets and similar practices), which are unfairly prejudicial to the interests of minority shareholders who hold fewer shares in the company.⁵

Corporate conflicts can be destructive when multiple disputes involving the desire for power and wealth and other personal feelings remain unresolved.⁶ In particular, Corporate conflicts involve ‘deep-rooted issues which are seen as non-negotiable’, whereas shareholder disputes are considered specific disagreements relating to the question of rights or interests in which disputing parties proceed through a range of dispute resolution methods, such as adjudication, mediation, avoidance, self-help and so on.⁷ In the corporate environment, the self-interested desire to increase power or wealth could further lead to the breakdown of the personal relationships between shareholders and result in deep-rooted conflicts in which issues are non-negotiable.⁸ In general, the most common types of behavioural patterns associated with distinctive characteristics of shareholder disputes in a small, closely held company such as marital discord,⁹ sibling rivalry¹⁰ and so on could disrupt the family business.

⁵ Sandra K. Miller, ‘Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French “Close Corporation Problem”’, *Cornell International Law Journal*, 30 (1997), 381–427 at 391 and John Farrar et al., ‘Dispute Resolution in Family Companies’, *Canterbury Law Review*, 18 (2012), 155–186 at 159.

⁶ Susanna M. Kim, ‘The Provisional Director Remedy for Corporate Deadlock: A Proposed Model Statute’, *Washington and Lee Law Review*, 60 (2003), 111–181 at 112.

⁷ John Burton, *Conflict: Resolution and Prevention* (New York: St. Martin’s Press, 1993), 2–3 and John Collier and Vaughan Lowe, *The Settlement of Disputes in International Law: Institutions and Procedures*, (Oxford: Oxford University Press, 1999), 1–2.

⁸ See generally *A & BC Chewing Gum Ltd* [1975] 1 All ER 1017, *Re Cumana Ltd* [1986] BCLC 430, *RA Noble and Sons (Clothing) Ltd* [1983] BCLC 273 and *North Holdings Ltd v. Southern Tropics Ltd* [1999] 2 BCLC 625. These cases decided by the UK courts reflect that self-interested behaviour led to the breakdown of the personal relationships between shareholders and caused disputes. See also *Russell v. Northern Bank Development Corporation Ltd* [1992] BCLC 1016. This case illustrates that the desire to increase power or wealth led to the breakdown of relationship between shareholders. The term ‘deadlock’ refers to ‘corporate paralysis stemming from disputes between equally powerful shareholder groups’. For details, see Note, ‘Mandatory Arbitration as a Remedy for Intra-close Corporate Disputes’, *Virginia Law Review*, 56 (1970), 271–294 at 271.

⁹ See, for example, *Chu Chung Ming v. Lam Wai Dan* [2014] HKEC 2132 (unreported, HCCW 377/2011, 22 December 2014) (CFI). This case illustrates that marital discord between a husband and wife can further sour their business relationship in a closely held corporation.

¹⁰ See, for example, *Kwok Ping Sheung Walter v. Sun Hung Kai Properties Ltd* [2008] 3 HKC 465, which is another example of shareholder disputes in Hong Kong where siblings are competing for the position of the chief executive officer and chairman.

INTRODUCTION

5

For instance, disputes can arise over the power to control business activities among members of the second generation after the passing of the founder of a family business.¹¹ The younger siblings may take an entrenched position with regard to either retaliation against the first-born for receiving preferential treatment or disagreement about the company's strategies. The younger siblings could form an alliance with other senior family members to usurp the first-born's authority by using squeeze-out techniques available under the majority rule to diminish the role or the stake of the first-born in the company. In this scenario, an unresolved dispute among the siblings and other family members within the company escalates into a full-blown crisis that would jeopardize the survival of the family business.

Clearly, there could be various possible underlying factors in shareholder disputes (such as unresolved issues from the past, sibling rivalry, interpersonal relationships, etc.) inviting a general state of hostility between members in a small private company (i.e., corporate conflicts). Corporate conflicts from which shareholder disputes emerge are undesirable, as these could eventually lead to the irretrievable breakdown in relations in a small private company (such as deadlock). To prevent the relational breakdown due to unresolved personal conflicts among shareholders in a small and closely held corporation, both the Hong Kong government and the Judiciary should aspire to developing a sophisticated dispute resolution system that offers a range of formal and informal dispute resolution processes for local businesspersons and their lawyers to choose from.¹² Further, such a system could reinforce Hong Kong's competitiveness and attractiveness as a global financial centre.

Over the past decades, the Hong Kong government has sought to emulate the United Kingdom's corporate legal framework by amending its Companies Ordinance virtually step-by-step tracking many of the

¹¹ See, for example, *Re Mak Shing Yue Tong Commemorative Association Ltd* [2005] 4 HKLRD 328, which is a typical example of how the death of the founder of a family business led to a disruption involving a breakdown of relationships among a number of grandchildren in that company. A winding-up on the just and equitable order was sought under Section 177(1)(f) of the Companies (Winding-Up and Miscellaneous Provisions) Ordinance (Cap. 32).

¹² Linda R. Singer, *Settling Disputes: Conflict Resolution in Business, Families, and the Legal System*, 2nd ed. (New York: Westview Press, 1994), 15–29. According to Singer, there are a variety ways to resolve shareholder disputes, ranging from the base of unassisted negotiation to the apex of traditional court adjudication process. See also John Lande, 'A Guide for Policymaking that Emphasizes Principles, and Public Needs', *Alternatives to High Cost Litigation*, 26:11 (2008), 197–205 at 204.

reforms in the United Kingdom.¹³ Court-based shareholder proceedings have been generally regarded as the most appropriate ways of dealing with shareholder disputes where the majority shareholders are exercising abusive power to gain outright control of the company, depriving the company minority of their rights and interests.¹⁴ Minority shareholders submit their disputes for resolution by a third-party judge, thereby surrendering a degree of control over the proceedings under this traditional, litigation-based approach to resolving minority shareholder disputes.¹⁵ An independent neutral judge has the authority to impose an authoritative decision on the parties based on evaluations of the pre-existing legal principles and the legal rights of the disputing parties. Generally speaking, there are three underlying reasons for the attractiveness of court-based shareholder proceedings under the statutory unfair prejudice provisions.

First, the statutory unfair prejudice remedy was initially introduced as an alternative to the just and equitable winding-up remedy in Hong Kong.¹⁶ This provision makes it easier for a minority shareholder to bring an action to the court in a case in which the nature of the complaint is related to the infringement of personal rights rather than a breach of duty to, or other misconducts actionable by, the company.¹⁷

In Hong Kong, the vast majority of companies are small and medium-sized enterprises.¹⁸ They are often formed on the basis of mutual trust originating from close and personal relationships between members.¹⁹

¹³ See, for example, the proposed rules of 4, 5, 6 and 9 of the new Companies (Unfair Prejudice Proceedings) Rules (Cap. 622) formulated with reference to the Companies (Unfair prejudice Applications) Proceedings Rules 2009 of the United Kingdom.

¹⁴ Farrar et al., 'Dispute Resolution in Family Companies', 159–161.

¹⁵ For details, see John H. Farrar and Laurence J. Boulle, 'Minority Shareholders Remedies – Shifting Dispute Resolution Paradigms', *Bond Law Review*, 13 (2001), 1–32 at 7–8.

¹⁶ Hong Kong Companies Law Revision Committee, *Company Law: Second Report of the Companies Law Revision Committee* (Government Printer, 1973) at paras. 5.95–103. In 1973, the Hong Kong Companies Law Revision Committee recommended introducing the statutory protection of minority shareholders. The underlying policy reason behind the introduction of a statutory remedy for minority shareholders is to provide more effective protection to this group. This recommendation was subsequently adopted and Section 168A was inserted by No. 51 of the Companies (Amendment) Ordinance 1978.

¹⁷ Corporate Governance Review by the Standard Committee on Company Law Reform: A Consultation Paper made in Phase I of the Review at para. 16.02. The underlying premise for the statutory remedies for shareholders is 'the member's personal right to be treated fairly'.

¹⁸ Statistics Relating to the Number of Local Companies Incorporated in Hong Kong.

¹⁹ *Ebrahimi v. Westbourne Galleries Ltd* [1973] AC 360 at 379.

Section 29(1) of the Hong Kong Companies Ordinance states that a private company is defined as a company which by its articles (a) restricts the rights to transfer its shares; and

A member in a small private enterprise typically places great reliance on the understandings that form the basis on which the company was formed to actively participate in the business affairs.²⁰ These understandings, however, are in fact not truly reflected in the articles or any other written agreements. The character of a quasi-partnership company was reflected in a seminal case, *Ebrahimi v. Westbourne Galleries Ltd*, where Lord Wilberforce stated that²¹

The words [“just and equitable”] are a recognition of the fact that a limited company is more than a mere judicial entity, with a personality in law of its own: that there is room in company law for recognition in fact that behind it, or amongst it, there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure.

On that basis, it is not uncommon that the statutory unfair prejudice remedy is usually sought by aggrieved shareholders in private companies, as the scope for finding expectations which are supplementary to a member’s strict legal rights is obviously greater in small quasi-partnership types of private limited companies.²²

Second, the court’s discretionary power in granting relief under the unfair prejudice provisions has been substantially enhanced through the Companies (Amendment) Bill 2004 and more recently the new Companies Ordinance (Cap. 622) which took effect on 3 March 2014.²³ Specifically, Section 725(2)(b) of the new Companies Ordinance expands the court’s discretion to grant corporate relief in an unfair prejudice petition.²⁴ This

(b) limits the number of its members to 50, not including persons who are in the employment of the company and persons who, having been formerly in the employment of the company, were while in that employment and have continued after the determination of that employment to be, members of the company; and (c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

²⁰ See, for example, *Grace v. Biagioli* [2006] BCC at 104.

²¹ AC 360 at 379.

²² Alan J. Dignam and John Lowry, *Company Law*, 8th ed. (Oxford: Oxford University Press, 2014), 234.

²³ Legislative Council, *Paper on Companies Bill Prepared by the Legislative Council Secretariat* (Background Brief), (2011); Hong Kong Financial Services and the Treasury Bureau, *New Companies Ordinance: Subsidiary Legislation for Implementation of the New Companies Ordinance* (Phase Two Consultation Document) (Hong Kong Financial Services and the Treasury Bureau, 2012), Part 12 and the Hong Kong SAR Government, *Press Releases: Companies (Unfair Prejudice Petitions) Proceedings Rules Submitted to LegCo* (15 May 2013).

²⁴ This provision is consonant with the theme running through English law that members of a company cannot claim for losses which merely reflect the company’s loss, i.e., reflective

provision can be viewed as the most remarkable improvement, as it provides greater clarity and certainty with regard to the court's power to grant damages in the event of unfair prejudice.²⁵ Also, the provision of Section 168A of the former Companies Ordinance (Cap. 32) is modified to be in line with the corresponding provisions in the UK Companies Act 2006, which extend the scope of unfair prejudice remedy to cover 'proposed acts or omissions'.²⁶

Third, the new statutory unfair prejudice remedy has proved to be more effective than the statutory derivative actions.²⁷ Remedies under the unfair prejudice provisions are much wider than both the common law and statutory derivative actions.²⁸ A list of specific remedies is set out in the unfair prejudice provision (such as the court's power to grant damages in circumstances of unfair prejudice, or a share purchase order for a buyout of the minority shareholders, etc.). This provision empowers the court to make any order that it thinks fit for giving relief. In addition, an unfair prejudice claim is generally perceived to be more attractive, as shareholders would not necessarily need to go through the expenses and uncertainties of a leave application.²⁹

However, Hong Kong's corporate legal framework is largely influenced by its UK counterpart, as it was a former British colony.³⁰ The English common law adversarial system maintains its influence over the manner in which evidence is to be adduced by the parties during the course

loss (*Prudential Assurance Co Ltd v. Newman Industries Ltd (No 2)* [1982] Ch 204 (CA (Civ. Div.))). This principle is reflected in Section 725(5) of the new Companies Ordinance. In *Re Lehman Brown Ltd* [2013] HKEC 357 (unreported, CACV 272/2011, 13 March 2013) (CA), the court held that the award of damages under Section 725(2)(b) (formerly Section 168A (2C)) should be set aside if it contravened the principle of reflective loss.

²⁵ Rita Cheung, 'Corporate Wrongs Litigated in the Context of Unfair Prejudice Claims: Reforming the Unfair Prejudice Remedy for the Redress of Corporate Wrongs,' *Company Lawyer*, 29:4 (2008), 98–104 at 101–102.

²⁶ Section 724(1)(b) of the Companies Ordinance (Cap. 622). A similar provision is found in Section 994(1)(b) of the UK Companies Act 2006.

²⁷ The statutory derivative action in the predecessor Sections 168BA to 168BK of the former Companies Ordinance (Cap. 32) is now found in Part 14, Division 4 (Sections 730 to 738) of the new Ordinance.

²⁸ Section 725(2) to (5) sets out the orders that the court can make upon finding that there is unfair prejudice following a petition under Section 724. This provision is derived from Section 168A(2), (2B), (2C) in the former Companies Ordinance (Cap. 32).

²⁹ Rita Cheung, *Company Law and Shareholders' Rights* (Hong Kong: LexisNexis, 2010), 293.

³⁰ Article 8 of the Hong Kong Basic Law stipulates that the laws previously in force in Hong Kong, i.e., the common law, rules of equity, ordinances, subordinate legislation and customary law shall be maintained, unless they contravene the Basic Law, and are subject to any amendment by the Legislative Council.

of unfair prejudice proceedings. Shareholder litigation remains costly, as the complexity of both the evidentiary and procedural rules may eventually lead to a greater reliance on lawyers to represent a lay businessperson who is without any litigation experience in court.³¹ Thus, the courts would have to serve as the last resort for minority shareholders whose legal or equitable rights or interests have been violated by those who control the majority of shares in a company.

Indeed, shareholders react to disputes not only through public court adjudicative process for settlement, but also through various techniques, including revenge, self-help, avoidance, negotiation, mediation and similar methods for handling disputes.³² Shareholder disputes involve both legal and non-legal elements that can influence not only the outcome of the case, but also the choice of a particular process.³³ Every procedure has its own characteristics. Shareholders and their lawyers can decide which dispute resolution methods fit their needs. In general, the basic processes for settling shareholder disputes are listed as follows:

- **Negotiation:** A quasi-partnership company enables shareholders to explore the possibility of early settlement by negotiating the terms of the buyout before trial.³⁴
- **Facilitative mediation:** This process opens the channel of communication that encourages the parties to maximize their chances of maintaining a good relationship in the future.³⁵
- **Collaboration and collaborative practice:** Like mediation, this process is a 'solution-oriented and interest-based process' that involves identification and selection of options and alternatives maximizing the

³¹ Alex Lau et al., 'In Search of Good Governance for Asian Family Listed Companies: A Case Study on Hong Kong', *The Company Lawyer*, 28:10 (2007), 306–311 at 310.

³² William L. F. Felstiner, 'Avoidance as Dispute Processing: An Elaboration', *Source: Law & Society Review*, 9:4 (1975), 695–706 at 695 and Donald Black, 'The Elementary Forms of Conflict Management', *New Directions in the Study of Justice, Law, and Social Control* (New York: Plenum Press, 1990), 43–62.

³³ Carrie Menkel-Meadow, 'From Legal Disputes to Conflict Resolution and Human Problem Solving: Legal Dispute Resolution in a Multidisciplinary Context', *Journal of Legal Education*, 54:1 (2004), 7–29 at 10.

³⁴ Philip Lawton, 'Modelling the Chinese Family Firm and Minority Shareholder Protection: The Hong Kong Experience 1980–1995', *Managerial Law*, 49:5/6 (2007), 249–271 at 263. According to Lawton, judicial support for an early buyout offer at a fair price is by far the most commonly sought remedy under the statutory unfair prejudice provisions.

³⁵ Frank E. A. Sander and Lukasz Rozdiczer, 'Matching Cases and Dispute Resolution Procedures: Detailed Analysis Leading to a Mediation-Centered Approach', *Harvard Negotiation Law Review*, 11 (2006), 1–41 at 35.

interests of all parties.³⁶ However, the most obvious difference between mediation and collaborative approach is ‘the dynamics of the process.’³⁷ The collaborative model enables the parties to work with a team of collaborative lawyers and other experts (such as psychologists, accountants and financial planners) in achieving mutually a satisfactory settlement.³⁸ The collaborative process could also be used in resolving shareholder disputes as this process offers not only individual support to each client.³⁹ In addition, the multidisciplinary nature of the collaborative practice offers specialized support from professionals in helping the parties to deal with sensitive and emotional issues.

- **Mini-trial:** Shareholders may strongly prefer a mini-trial if they want to minimize the costs associated with the lengthy investigation of the unfair prejudice conducts during the court litigation process. A mini-trial is generally considered a suitable alternative means of resolving shareholder disputes where shareholders seek to explore the possibility of early settlement. In the mini-trial, a neutral third party can make an early assessment of the strengths and weaknesses of each side’s case and the likely outcome of litigation.⁴⁰
- **Expert determination:** Expert determination is a common mode of informal dispute resolution process used to resolve shareholder disputes.⁴¹ In expert determination, a neutral third party is appointed by the parties who possesses sufficient technical expertise in the subject matter of the disputes to bring to bear in the making of decisions. The nature of expert determination makes it particularly suitable to solving unfair prejudice cases where the only outstanding issue is a technical matter such as the valuation of minority’s shareholdings in the event of a buyout.⁴²
- **Arbitration:** This process has generally been preferred over litigation for resolving cross-border shareholder disputes as the enforcement of arbitration agreements is secured by the most important international

³⁶ P Oswin Chrisman et al., ‘Collaborative Practice Mediation: Are We Ready to Serve This Emerging Market’, *Pepperdine Dispute Resolution Law Journal*, 6:3 (2006), 451–464 at 453.

³⁷ Robert Lopich, ‘Collaborative Law Overview: Towards Collaborative Problem-solving in Business’, *ADR Bulletin*, 10:8 (2009), 161–166 at 163–165.

³⁸ Ibid.

³⁹ Ibid. at 165–166.

⁴⁰ Catherine Cronin-Harris, ‘Mainstreaming: Systematizing Corporate Use of ADR’, *Albany Law Review*, 59 (1995), 847–879 at 853.

⁴¹ For details, see Chapter 2.

⁴² See, for example, *O’Neill v. Phillips* [1999] BCC.

treaty, namely, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Award (the New York Convention 1958).⁴³

- **Adjudication:** A court adjudicative process is particularly suitable where both parties have the desire to discontinue their business relationship and to achieve a clean break.⁴⁴

Obviously, court-based shareholder proceedings are by no mean the most superior settlement procedures. First, the underlying causes of shareholder disputes including misunderstandings, feelings and personality clashes are often overlooked or ignored by either the court or the corporate lawyers. These subjective aspects of shareholder disputes are, in fact, located at the submerged part of the iceberg, and it is not always a straightforward matter for the court or lawyers to identify one factor or a combination of factors which contribute to the breakdown of a quasi-partnership type company (see Figure 1.1).⁴⁵

In general, the role of the court is not to investigate who or what caused the breakdown of personal relationships between shareholders.⁴⁶ Instead, the focal point of the court's enquiry in determining whether a shareholder has been prejudiced in an unfair manner is the effect of the opportunistic conduct of the majority and not the nature of the conducts that are the subject of the complaint.⁴⁷ Judges often miss the true cause of a dispute (such as personality clashes) as they concentrate on the 'objective aspects' of shareholder disputes and the application of law and equity in determining whether the conduct complained about is unfairly prejudicial to

⁴³ See generally Stavros L Brekoulakis, 'The Notion of the Superiority of Arbitration Agreements Over Jurisdiction Agreements: Time to Abandon It?', *Journal of International Arbitration*, 24:4 (2007), 341–364.

⁴⁴ James Carter and Sophie Payton, 'Arbitration and Company Law in England and Wales', *European Company Law*, 12:3 (2015), 138–143 at 143.

⁴⁵ Jeremy Lack, 'Appropriate Dispute Resolution (ADR): The Spectrum of Hybrid Techniques Available to the Parties' in Arnold ingen-Housz (ed.), *ADR in Business: Practice and Issues across Countries and Cultures*, Vol. II (The Hague: Kluwer Law International, 2011), 341–342.

⁴⁶ *O'Neill v. Phillips* [1999] BCC 600 at 612.

⁴⁷ *Re Yung Kee Holdings Ltd* [2012] HKEC 1480 (unreported, HCCW 154/2010, 31 October 2012) (CFI) at para. 116 and *Anthony A Sperandeo v. George Lencsak* [2015] HKEC (unreported, HCMP 1022/2013, 4 December 2015) at para. 11. See also D. D. Prentice, 'The Theory of the Firm: Minority Shareholder Oppression: Sections 459–461 of the Companies Act 1985', *Oxford Journal of Legal Studies*, 8:1 (1988), 55–91 at 78 and David Milman, 'The Rise of the Objective Concept of 'Unfairness' in UK Company Law', *Company Law Newsletter*, 286 (2010), 1–4.