

Case Bulletin: 2020/01

Court Refused to Interfere with the Internal Affairs of a Company

Under common law, directors owe fiduciary duties to the company, not to its shareholders. If the directors breach their fiduciary duties or commit wrongs against the company, disgruntled members may be able to commence litigation through a derivative action under common law and/or section 732 of the Companies Ordinance (Cap. 622) (“CO”) on behalf of the company. Alternatively, a member or creditor may apply to the court under section 729 of the CO for appropriate remedies, such as an injunction, an order for damages, or a declaration of any contract to be void.

In *Fountain II Limited v Ping An Securities Group (Holdings) Limited & Others* [2019] HKCFI 3013, a member sought an injunction against the company’s proposed rights issue under sections 724 and 729 of the CO. The application was refused. It was held that as a general proposition of law, the court should be very slow to interfere in the internal affairs of a company. Cogent evidence, not a mere speculation, is required to find that directors have been acting improperly, particularly when an injunction that is being sought would finally dispose of the matter.

I. Background

1. An affiliate of Haitong sought an injunction against Ping An Securities (“Ping An”, the 1st Respondent) and other Respondents in respect of Ping An’s proposed rights issue.
2. Well Up (the 7th Respondent) owns 55.8% shares of Ping An, and it borrowed money from Haitong based upon the security of a share pledge of Ping An.

Court Refused to Interfere with the Internal Affairs of a Company

Save a tiny percent of shares which Haitong legally owns, Haitong is not a creditor of Ping An and has no interest in the 55.8% of charged shares of Ping An, other than a contractual right in causing Well Up to vote.

3. An event of default occurred under the loan, and Haitong suggested that Well Up was insolvent and pursuant to Haitong's exercise of rights under the security, the economic interests in Ping An was vested in Haitong.
4. Haitong alleges that the management of Ping An was seeking to dilute Haitong's economic interest by way of a rights issue, with an improper motive to remove Haitong's ability to dislodge the existing management. Also, the rights issue would effectively reduce the stake from 55.8% down to 37%, depressing the price because the control premium would be lower.
5. Haitong claims that the board of Ping An was among others in breach of fiduciary duty, shareholders' legitimate expectation, and conducting the company in a matter which is unfairly prejudicial to the interests of Haitong and the public investors.

II. Key Points

1. A number of principles in support of the general propositions of law that the court should be very slow to interfere in the internal affairs of a company were cited:
 - (1) The court will generally not second-guess the correctness of *bona fide* commercial decisions of the board, *Passport Special Opportunities Master Fund LP & Another v eSun Holdings Ltd & Others* [2011] 4 HKC 62 at §150;
 - (2) The burden of proof is to be discharged by “*evidence, not by assertion and speculation*”, *Able Success Asia Ltd v. China Packaging Group Co Ltd & Others* (HCMP 1091/2014 at §63);
 - (3) “*Once it is shown that a company does need funds, it is a matter for its management and its commercial decision on whether those funds should be raised by way of placement or other methods. The Court*

should not interfere with bona fide management decision and substitute its own opinion for that of the management”, Kwok Shun On v Wong Sai Wing [2001] 3 HKLRD 811 at §73.

2. It requires particularly cogent evidence when the injunction which is being sought would finally dispose of the matter.

III. Findings

The judge found that holding of small amount of shares was sufficient to create *locus* to bring an unfair prejudice petition. However, the judge refused to consider the economic effect of 55.8% of shares that Haitong did not legally own. On the facts, the judge found that Haitong’s contentions were merely speculations. While there was some conducts that caused some concerns to the judge, however, there was insufficient evidence for drawing a serious inference that the directors acted improperly. On balancing convenience, the judge found that Haitong had knowledge of the capital reorganization proposal and could have caused Well Up to remove the directors at an early stage. There were also corporate and personal guarantees to secure the loan and for Haitong to seek recovery of its economic loss. In the circumstances, the injunction application was dismissed.

For enquiries, please contact:

Dennis Fong & Co., Solicitors *(in Association with Links Law Offices)*

Adrian Lo

Partner

Tel: +852 2592 1978

Email: adrian.lo@llinkslaw.com.hk