

New light shed on remedies for protection of shareholders' interests in *Ge Qingfu v L&A International Holdings Ltd*

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Introduction

Under section 729 of the Companies Ordinance (Cap 622) (the **Ordinance**), where a director of a company is found to have breached his fiduciary duties towards the company, the Court of First Instance (the **Court**) has the powers to grant relief to individual members to redress the harm that has been done to their personal legal rights. The recent decision of *Ge Qingfu v L&A International Holdings Ltd* [2018] HKCFI 2742 illustrates the application of s729 and also sheds new light on the Court's power to award damages under this provision.

Background to the Dispute

L&A International Holdings Limited (the **Company**) is a company listed on the GEM board of the Hong Kong Stock Exchange.

On 22 July 2016, a company named Favourite Number Limited (**FNL**) notified the Company of its intention to make a voluntary offer for all of the issued shares in the Company. The formal offer (**General Offer**) was announced on 18 August 2016. The Company subsequently announced that 2,000,000,000 share options (**Disputed Options**) had been granted on 22 July 2016 to ten eligible participants of its share option scheme (**Share Option Scheme**). The Next Day Disclosure Return submitted on 24 August 2016 showed that 1.6 billion new shares (**Disputed Shares**) had been issued and allotted upon the exercise of the Disputed Options. The Company, however, had never disclosed the granting of the Disputed Options prior to 22 August 2016. Indeed, FNL announced on 2 September 2016 that it was prejudiced by the Company's failure to disclose the Disputed Options in that it then had to put

forward more financial resources and time to proceed with the General Offer. FNL eventually withdrew the General Offer.

Unaware that their shareholding had been diluted as a result of the Disputed Shares, the Plaintiffs, as members collectively holding more than 10% of the issued share capital of the company, requested the board to convene an EGM in an attempt to remove all the directors on the board. When they realised their combined interest fell below 10% as a result of the allotment of the Disputed Shares, the 1st Plaintiff spent approximately HK\$18 million to buy additional shares from the market to maintain a "more than 10%" shareholding in the Company so as to further the Plaintiffs' efforts to raise a requisition for an EGM.

In late 2016, the Plaintiffs commenced proceedings against the Company, the directors at the material time and also the grantees of the Disputed Options, seeking various forms of relief, including mandatory injunction and damages. By the time of the commencement of the proceedings, the grantees had already exercised the options and sold the shares to third parties. The Plaintiffs settled the case with these grantees before trial.

A key issue at trial was whether the directors breached their fiduciary duties owed to the Company when granting the Disputed Options and allotting the Disputed Shares, which is a prerequisite to the granting of relief under s729. The Defendants' case was that the board met to decide to grant the Disputed Options on 22 July 2016 for the purpose of pacifying a discontented personnel of its subsidiary and incentivising

certain consultants and advisers to the Company. The Defendants asserted that the granting of the Disputed Options was not intended to block or obstruct the General Offer and that they inadvertently failed to timely disclose the Disputed Options.

It is notable that, a few days prior to this decision, the GEM Listing Committee of the Hong Kong Stock Exchange censured the Company and the 3rd, 5th, 6th and 7th Defendants in these proceedings for various breaches of the GEM Listing Rules concerning the grant of the Disputed Options.¹

Breach of Directors' Duties and Improper Purpose

One of the factual issues in dispute was whether the Company's board resolved to grant the Disputed Options on 22 July 2016 as contended by the Defendants. Having considered the evidence adduced by both sides (in particular *viva voce* evidence of some of the Defendants), the Court found that the board did not make the decision on 22 July 2016 but sometime between early to mid-August 2016 instead. Further, the documentation pertaining to the purported grant of the Disputed Options adduced by the Defendants (including the minutes of the board meetings on 22 July 2016) were fraudulently backdated to 22 July 2016.

The Court also rejected the Defendants' evidence as to the real reason behind the grant of the Disputed Options and inferred that the real purpose was attempting to block or obstruct the General Offer, which must be an improper purpose. This was so notwithstanding the fact that one of the grantees could be rightly regarded as an eligible person under the Company's share option scheme. The Court was clear that *even in*

the case of this grantee, the grant would still be "entangled" with the predominant improper purpose. On the whole, the Court found that the directors "*faked a story about having granted the Disputed Options on 22 July 2016 with the improper purpose of blocking the General Offer*". That finding in itself is a finding of a breach of fiduciary duties on the part of the directors concerned.

As mentioned above, the GEM Listing Committee had censured the Company and various board members for breaches of the GEM Listing Rules (such as for the delay in disclosing the Disputed Options). This censure was based on the apparent contention that the board had resolved to grant the relevant options on 22 July 2016. Now that the Court has found that the Disputed Options were granted in early to mid-August 2016 instead, this issue of lateness may appear less significant. However, a finding by the Court of fraudulent acts on the part of the management of a listed company may lead to findings of more severe regulatory breaches or offences.

The Court's Power to Grant Damages under Section 729

Once a director is found to have breached his fiduciary duties, the Court has powers to grant an injunction, order the wrongdoer to pay damages to any other person and declare a contract to be void or voidable under s729. We have seen cases where individual members sought injunctive reliefs under this provision. However, seeking damages is rare.

In the present decision, Counsel for the 3rd to 7th Defendants argued that the Plaintiffs were not entitled to claim damages when there was no prospect that an injunction would be granted

¹ In approving the grant during a blackout period and failing to disclose the grant in a timely manner

(since the Disputed Shares were already sold in open market, there was no prospect of the Court granting an injunction). The Defendants sought to rely on the predecessor of ss728 - 730 of the Ordinance² and its Australian counterpart³ to support this proposition.

The Court disagreed with the Defendants' argument and held that its power to grant relief under ss728 to 730 is not parasitic to its power to grant injunctions. Instead, s729 is a new piece of legislation not to be shackled by its predecessors or forerunners. The power to award damages is only subject to the limitation against reflective losses.

The Court also made clear that the person to be awarded damages needs not be the particular "member or creditor" making the application, as long as he can prove that he has suffered pecuniary loss resulting from the breach.

In the end, the 1st Plaintiff was awarded damages in the sum of his costs of buying the additional shares in order to restore the Plaintiffs' shareholding above 10%.

The Plaintiffs also sought other reliefs, including an order that the Defendants buy back 1.6 billion shares from the market and return them to the Company. The Court refused to grant the order which is in the nature of a mandatory injunction, taking into consideration that these proceedings were not derivative action concerning the Company's rights and the Plaintiffs' legal rights could adequately be redressed by damages. The Court also refused to declare that the granting of the Disputed Options and the allotment of the Disputed Shares were void as that would adversely affect innocent third parties who had purchased the Disputed Shares on the market without even affording them an opportunity to be heard.

Conclusion

In an unprecedented instance of the Court relying on s729 to grant standalone damages, this case not only serves as a reminder for directors to exercise their powers for a proper purpose, but also illustrates s729's position as a new piece of legislation with potentially broader powers than its predecessor.

² s350B of the former Companies Ordinance (Cap 32)

³ s1324 of the Corporations Act 2001 in Australia

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