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Legal Pitfalls that Start Ups Need to be Aware of

Agenda

- 1. Articles of Association
- 2. Shareholders' Agreement / Other Agreements
- 3. Litigation or Arbitration?
- 4. Shareholder Litigation
 - Unfair Prejudice Petition
- 5. Shareholder Litigation
 - Just and Equitable Winding Up Petition
- 6. Director's Fiduciary Duties and Liabilities



1. Articles of Association

- **3 types of Companies**
 - Public companies limited by shares
 - Private companies limited by shares
 - Companies limited by guarantee



1. Articles of Association

- Statutory contract binding on members and company
- A constitutional document contain provisions regulating
 - (1) the relationship between the company and outsiders; and
 - (2) the relationship between the company and its members
- Model Articles for Private Companies Limited by Shares: Sch.2 to the Companies (Model Articles) Notice (Cap. 622H)
- Model Articles for Public Companies Limited by Shares and Companies Limited by Guarantee: Sch.1 & Sch.3



2. Shareholders' Agreement

- **A private contract between shareholders**
 - Regulate relationship of shareholders in their personal capacity
 - Right of participation in the management of the company
 - Any breach enables innocent party to contractual remedies



2. Shareholders' Agreement

- **A private contract between shareholders**
 - Cannot amend shareholders' agreement without consent of minority
 - Higher flexibility, no formality
 - Privacy – private contract
 - Not a public document – not registrable at Companies Registry
 - Preserve confidentiality of the relationship between shareholders and terms agreed between the parties



2. Shareholders' Agreement

- **A private contract between shareholders**
 - Dealing with matters inappropriate to be included in Articles of Association
 - Management structure – minority's right
 - Restrictive covenants – non-competition clause
 - Dividend policy – commercial decision



2. Other Agreements

- E.g. Investment Agreement / Loan Agreement / Share Subscription Agreement
- Private contracts between investors / shareholders / directors / outsiders and the company
- Shareholders / Directors of the company would usually be a party to the contract (to act as guarantors or to impose contractual obligations to the shareholders / directors)
- Breach of agreement – recourse against the shareholders / directors?

3. Litigation or Arbitration ?

- **Court litigation**
 - Breach of shareholders' agreement / other agreements
 - Unfair prejudice petition
 - Just and equitable winding up petition
- **Arbitration**
 - Alternative dispute resolution
 - Must be agreed by the parties in order to invoke arbitration proceedings
 - Institutional arbitration / ad hoc arbitration

3. Litigation or Arbitration ?

- **Advantages of arbitration**
 - Privacy – confidentiality of arbitration
 - Expertise of arbitrators (construction, intellectual property, IT, etc.)
 - Flexibility – can resolve disputes much sooner than litigation
 - Party's autonomy
 - Choice of arbitrator
 - Choice of procedure
 - Finality (normally cannot appeal)
 - Can enforce the award in countries which have signed the New York Convention (159 state parties as at April 2018)

3. Litigation or Arbitration ?

- **Disadvantage of arbitration**
 - More expensive in terms of the procedure – e.g. pay for venue, administration fees, translation and the costs of arbitrators
 - Difficult for multi-parties dispute – no joinder of parties unless agreed by the parties
 - Difficult to appeal against arbitral awards
 - Different and quality standards of arbitrators

3. Litigation or Arbitration ?

- **Advantage of litigation in Court**
 - Can apply for injunctive or interlocutory relief – may resolve dispute without the need to pursue the matter to trial
 - Relatively less expensive than arbitration
 - Can appeal against the judgment
 - Expedited procedures which may obtain final judgment without the need to proceed to trial – e.g. default judgment, summary judgment.

3. Litigation or Arbitration ?

- **Disadvantage of litigation in Court**
 - No privacy as open to public
 - Judges may not possess the expertise (construction, intellectual property, IT, etc.)
 - No finality – judgments are subject to appeal
 - May take 2-3 years to proceed a matter to trial, and 2-3 years more for the appeal
 - Difficult to enforce judgment in other countries

4. Shareholder Litigation – Unfair Prejudice Petition

- Pt.14, Division 2, ss.711-716, CO confers a member a statutory right to **petition unfair prejudice to court** for appropriate orders if the company's affairs have been unfairly prejudiced to the interests of the petitioner, or an actual or proposed act or omission of the company would be so prejudicial

4. Shareholder Litigation – Unfair Prejudice Petition

- What is **Unfair Prejudice**?
 - Internal disputes about alleged breaches of terms or **understandings** upon which parties intended to co-exist as members of co
 - The prejudice must also be unfair - not of unlawfulness

4. Shareholder Litigation – Unfair Prejudice Petition

- A member will not ordinarily be entitled to complain of unfairness unless there has been
 - Breach of the Articles of Association;
 - Breach of fiduciary duty by the directors; or
 - Breach of **some formal or informal promise or understanding** between the parties which forms the basis of how the company's affairs should be conducted (though not put into contractual form)

4. Shareholder Litigation – Unfair Prejudice Petition

- **The concept of fairness**
 - Comprise breach of either the terms on which it was agreed the affairs of the company should be conducted (or of equitable constraints which apply to the exercise of legal powers) by reason of **the nature of the relationship between the parties**
 - Such that makes it unfair for the majority to insist on legal rights, or to exercise them in a particular way
 - valid exercise of powers conferred by Articles of Association may nevertheless be entirely outside what can fairly be regarded as having been in the contemplation of the parties when they became members of the company

4. Shareholder Litigation – Unfair Prejudice Petition

- **Quasi partnership?**
 - A quasi partnership evolves from an informal business partnership which is later incorporated but where the relationships btw the participants largely remain the same
 - Personal relationship involving mutual confidence
 - Where the incorporators know each other well and may have worked well since trading in unincorporated form
- However, when parties are sophisticated and experienced investors with complex docs, it is not a quasi partnership

4. Shareholder Litigation – Unfair Prejudice Petition

- **Examples of Unfair Prejudice**
 - Exclusion from management
 - Excessive remuneration
 - Inadequate dividends and non-participation in company's profit
 - Breaches of fiduciary duties of directors
- Negligence in the form of commercial misjudgements and management errors will rarely amount to unfair prejudice
 - Significant and serious mismanagement of a company's affairs or business can amount to unfairly prejudicial conduct

4. Shareholder Litigation – Unfair Prejudice Petition

- **Reliefs** – Court has a very wide discretion to grant remedies ‘to make such order as it thinks fit’: s.725(1), CO
 - Requiring the company to do, or refrain from doing certain acts
 - Authorising civil proceedings to be brought on behalf of the company
 - Appointing receiver or manager
 - Regulating the conduct of company’s affairs
 - **Ordering share purchase**
 - Awarding damages and interest against the wrongdoer

4. Shareholder Litigation – Unfair Prejudice Petition

- **Buy-Out**
 - The most important and commonly granted remedy (for small company) is an order for the purchase by the majority of the minority's shares at a fair price
 - **No discount rule:** in the case of a quasi-partnership, no discount should be applied for a minority shareholding, because they are forced to leave the company and this provides the majority an incentive to seek an agreed sale with the minority

4. Shareholder Litigation – Unfair Prejudice Petition

- **A discounted basis may be appropriate**
 - Where the minority has bought his shares at a discounted value
 - Where the minority has acted so as to deserve exclusion
 - Where the minority acquired shares purely for investment, and played no part in the affairs of company, then it might be appropriate to be bought out on the same basis, even if unfair prejudice
 - Where the minority has purchased the shares as preference shareholders, who are essentially investors (rather than quasi-partners) in the company

5. Shareholder Litigation – Just and Equitable Winding Up Petition

- Minority shareholder may apply to court to have the company wound up on the ‘**just and equitable**’ grounds: s.177(1)(f), **Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (“CO32”)**
- **Effect of a Winding up order**
 - Bring the life of the company to an end and for its affairs to be wound up by a liquidator under the supervision of court
 - Company’s assets are sold off, creditors are repaid
 - The surplus of assets is distributed to shareholders in accordance with their proportionate shareholdings

5. Shareholder Litigation – Just and Equitable Winding Up

- **Concern**
 - On a forced sale by a **Liquidator** (a neutral person) the assets may not be realised anything like the value they had while the company was a going concern, the potential loss of value may make the minority shareholder hesitate before applying for an order

5. Shareholder Litigation – Just and Equitable Winding Up

- **What is Just and Equitable?**
 - “Just and equitable” recognise that a company is more than a mere legal entity, behind it there are individuals, with rights, expectations and obligations inter se which are not necessarily submerged in the company structure
 - The “just and equitable” provision does not entitle one party to disregard the obligation he assumes by entering a company, nor the court to dispense him from it
 - It enables the court to subject the exercise of legal rights to equitable considerations, i.e. considerations of a personal character arising between one individual and another, which may make it unjust, or inequitable, to insist on legal rights, or to exercise them in a particular way

5. Shareholder Litigation – Just and Equitable Winding Up

- An association formed or continued on the basis of a personal relationship involving mutual confidence
- An agreement, or understanding, that all, or some (for there may be 'sleeping' members), of the shareholders shall participate in the conduct of the business
- However, when disputes arise between the shareholders and there is **restriction upon the transfer of the members' interest** in the company, the minority cannot take out his stake and go elsewhere

5. Shareholder Litigation – Just and Equitable Winding Up

- **Examples**
 - Exclusion or expulsion from management of a shareholder whose equal participation in management was part of the agreed basis or understanding on which the company was formed
 - Where the agreement between the parties is for something less than day to day participation in management but where the parties have clearly agreed the petitioner would be consulted on all major decisions but the respondent majority shareholder has run the company as if it were exclusively his own
 - Where the petitioner can prove the persons managing the company's affairs lack honesty or probity to such an extent that it is unreasonable to expose the petitioner's investment in the company to their machinations

5. Shareholder Litigation – Just and Equitable Winding Up

- **Examples**
 - Where principal objects of the company can no longer be achieved (frustration), **especially for start-up company**
 - Where the affairs of the company have become deadlocked as the result of the shareholders and directors refusing to speak or co-operate with each other (company cannot function)
 - Where the petitioner can show the directors and majority shareholder active in the management of the company are in receipt of generous remuneration but have refused to pay any dividends to the other shareholders not involved in management and have therefore deprived them of any real return on their investment in the company

6. Director's Fiduciary Duties and Liabilities

- **Who “control” a company?**
 - **Board of Directors**
 - General management power rests on the Board (business and affairs)
 - **Shareholders (members)**
 - Only a special resolution can give directions to the board by shareholders in the general meeting
 - Removal of director
 - Alter the Articles of Association

6. Director's Fiduciary Duties and Liabilities

- **Directors**
 - A director owes fiduciary duties and common law duty of care and skills **to the company** (i.e. shareholders as a whole in a collective unit) and **not** to individual shareholders, therefore general management power rests in the Board
 - Articles delegate the general management power to the Board and the shareholders generally cannot intervene

6. Director's Fiduciary Duties and Liabilities

- **Directors' fiduciary duties**
 - Exercise reasonable care, skill and diligence
 - The care, skill and diligence that would be exercised by a reasonably diligent person with
 - (i) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the directors in relation to the company (objective test); and
 - (ii) the general knowledge, skill and experience that the director has (subjective test)
 - Fiduciary Duty of Loyalty (act bona fide in the best interests)
 - Exercise powers for proper purposes
 - No Conflict-No Profit Rules

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- Transactions at an undervalue – voidable transaction: s.265D, CO32

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- A transaction at an undervalue means:-
 - The company makes a gift to that person, or otherwise enters into a transaction with that person on terms that provide for the company to receive no consideration; or
 - The company enters into a transaction with that person for a consideration the value of which, in money or money's worth, is significantly less than the value, in money or money's worth, of the consideration provided by the company

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- Unfair preferences – voidable transaction: s.266, CO32

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- A company gives an unfair preference to a person if
 - (a) that person is
 - (i) one of the company's creditors; or
 - (ii) a surety or guarantor for any of the company's debts or other liabilities; and
 - (b) the company does anything or suffers anything to be done which has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position that person would have been in if that thing had not been done

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- Avoidance of dispositions of property after commencement of winding up – voidable transaction: s.182, CO32

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- S182: In a winding up by the court, any disposition of the property of the company, including things in action, and any transfer of shares, or alteration in the status of the members of the company, made after the commencement of the winding up, shall, unless the court otherwise orders, be void

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- Responsibility of directors for fraudulent trading – s275, CO32

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- S275: If in the course of the winding up of a company it appears that any business of the company has been carried on with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose, the court, on the application of the Official Receiver, or the Liquidator or any creditor or contributory of the company, may, if it thinks proper so to do, declare that any persons who were knowingly parties to the carrying on of the business in manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct.

6. Director's Fiduciary Duties and Liabilities

- Director's potential liabilities after the company is wound up
- Damages against delinquent officer – s276, CO32

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- S276: If in the course of winding up a company appears that any of the persons specified in subsection (1A) has misapplied or retained or become liable or accountable for any money or property of the company, or been guilty of any misfeasance, breach of duty or breach of trust in relation to the company which is actionable at the suit of the company, the court may, on the application of the Official Receiver, or of the liquidator, or of any creditor or contributory, examine into the conduct of the person, and compel the person to repay or restore the money or property or any part thereof respectively with interest at such rate as the court thinks just, or to contribute such sum to the assets of the company by way of compensation in respect of the misapplication, retainer, misfeasance, breach of duty or breach of trust as the Court thinks just.

6. Director's Fiduciary Duties and Liabilities

- **Director's potential liabilities after the company is wound up**
- s276(1A): The following persons are specified for subsection (1):
 - (a) a person who is or has been an officer of the company;
 - (b) a person who is or has acted as a provisional liquidator or liquidator of the company;
 - (c) a person who is or has acted as a receiver or manager of the property of the company;
 - (d) a person, other than a person falling within paragraph (a), (b) or (c), who is or has been concerned, or is taking or has taken part, in the promotion, formation or management of the company

Q&A



THANK YOU





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